10 Tax and Accounting Considerations for Restaurants and Bars

Since 1984, Newburg & Company, LLP has been working with restaurants throughout the New England area. Below, we have compiled a list of some of the more important tax and accounting issues impacting restaurants and bars today (in no particular order of importance).

1. DEPRECIATION OPPORTUNITIES

The cost of updating and refurbishing a restaurant, retail store or other leased commercial property may be fully deductible in 2010 and 2011. Expanded expensing rules were contained in new tax legislations under the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010".

Highlights

- 50% bonus depreciation and Alternative Minimum Tax (AMT) depreciation relief are extended through Dec. 31, 2012
- 100% bonus depreciation is allowed after Sept. 8, 2010 and before Jan. 1, 2012
- Code Sec. 179 expensing limit increases to $500,000 and phase-out threshold increases to $2,000,000 for tax years beginning in 2010 and 2011
- Up to $250,000 of "qualified real property" is eligible for Code Sec. 179 expensing in tax years beginning in 2010 and 2011
- 15 year depreciation for certain real property is extended through 2011 for qualified leasehold improvements, restaurant buildings, and retail improvements (instead of previous 39 year recovery period)
- Increase in first-year depreciation cap for cars that are "qualified property" is extended through 2012

Extension of 50% bonus first-year depreciation. Businesses are allowed to deduct the cost of capital expenditures over time according to depreciation schedules. In previous legislation, Congress allowed businesses to more rapidly deduct capital expenditures of most new tangible personal property, and certain other new property, placed in service in 2008 or 2009 (2010 for certain property), by permitting the first-year write-off of 50% of the cost. The new law extends the first-year 50% write-off to apply to qualifying property placed in service through December 31, 2012. In addition, 100% bonus depreciation is allowed after Sept. 8, 2010 and before Jan. 1, 2012.

Enhanced small business expensing (Section 179 expensing). In order to help small businesses quickly recover the cost of certain capital expenses, small business taxpayers can elect to write off the cost of these expenses in the year of acquisition in lieu of recovering these costs over time through depreciation. Under pre-2010 Small Business Jobs Act law, taxpayers could expense up to $250,000 of qualifying property-generally, machinery, equipment and certain software-placed in service in tax years beginning in 2010. This annual expensing limit was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service in tax years beginning in 2010 exceeded $800,000 (the investment ceiling). Under the new law, for tax years beginning in 2010 and 2011, the $250,000 limit is increased to $500,000 and the investment ceiling to $2,000,000.

The new law also makes certain real property eligible for expensing. For property placed in service in any tax year beginning in 2010 or 2011, the up-to-$500,000 of property expensed can include up to $250,000 of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).

Examples of improvements that may qualify are:

- Permanent lighting and electrical systems
- Plumbing systems
- Security and sprinkler systems
- Ceilings (acoustical panels, etc.)
- Windows, doors, etc.
- Flooring and new walls, etc.

The following improvements **do not** qualify for the expensing election:

- Enlarging or expanding existing building
- Common area structural components
- Addition of escalators or elevators
- Costs impacting the internal framework of the building

2. REVIEW POTENTIAL NEW HEALTH CARE TAX CREDIT

Small employers, including tax-exempt organizations that pay some, or all, of the cost for their employee's health care coverage may be able to cut their tax bill substantially in 2010 by taking advantage of the new health care tax credit.

The new health care tax credit is designed to assist small businesses who offer health coverage to their employees. In 2010 through 2013, the maximum credit is 35 percent (50% for tax years beginning after 2013) of the employer's eligible premium expenses. Claiming this credit can result in a substantial tax savings. The business must have no more than 25 full-time equivalent employees (“FTEs”), and the employees must have annual full-time equivalent wages that average no more than $50,000 (duel phase out over 10 FTEs and $25k average).

For example, if you paid $72,000 in health care premiums for your employees and you meet all the requirements for the full amount of the credit, you could claim a credit for $25,200 (35% x $72,000).

There are two tests that you have to meet to qualify for this credit: you must be a "qualified employer" and you must pay the premiums under a "qualifying arrangement."

3. REVIEW POTENTIAL PAYROLL TAX CREDIT

Payroll tax holiday and up-to-$1,000 credit for employers who hire unemployed workers. To help stimulate the hiring of workers by the private sector, the new law exempts any private-sector employer that hires a worker who had been unemployed for at least 60 days from having to pay the employer's 6.2% share of the Social Security payroll tax on that employee for the remainder of 2010. A company could save a maximum of $6,621 if it hired an unemployed worker and paid that worker at least $106,800-the maximum amount of wages subject to Social Security taxes-by the end of the year. As an additional incentive, for any qualifying worker hired under this initiative that the employer keeps on payroll for a continuous 52 weeks, the employer is eligible for an additional nonrefundable tax credit of up to $1,000 after the 52-week threshold is reached, to be taken on their 2011 tax return. In order to be eligible, the employee's pay in the second 26-week period must be at least 80% of the pay in the first 26-week period. Workers hired after the date of introduction of the legislation (Feb. 3, 2010) are eligible for the payroll tax forgiveness and the retention bonus, but only wages paid after the date of the new law's enactment receive the exemption for payroll taxes.

4. TAKE ADVANTAGE OF THE TIP CREDITS AVAILABLE TO YOU

All too often, we have seen new restaurant clients that have not taken advantage of previous years tip credits available to them. Typically, the calculation of this report is prepared by your payroll company. If the payroll company does not offer this service, you will need to check with your accountant to assist with the calculation. This credit relates to the Social Security taxes you pay on an employee's cash tip income which is treated (for tax purposes) as paid by you to the employee. The credit applies with respect to tips received from customers in connection with the provision of food or beverages, regardless of whether the food or beverages are for consumption on or off the premises.

These tips are required to be reported to you by the employee; however, you may still take the credit even if the employee did not report the tips to you.

The credit only applies to the tip income that brings your employee's wages over $5.15 per hour, which was the minimum wage on Jan. 1, 2007. (In 2007 tax legislation that was tied to passage of the increase in the minimum wage, Congress in effect froze the FICA tax credit based on pre-2007 law so that the credit wouldn't be affected by the increase in the minimum wage hourly rate amending the Fair Labor Standards Act of '38 to $7.25 in three 70-cent increments. The minimum wage increases from $5.15 to $5.85 as of July 24, 2007, to $6.55 as of July 24, 2008, and to $7.25 as of July 24, 2009.) In other words, to the extent the tip income just brings the employee up to the minimum wage level, no credit is available. Calculations are made on a monthly basis.

> *Example:* Felix is a waiter in the ABC Restaurant. He is paid $2 an hour plus tips. During the month, he works 160 hours for $320 and receives $2,000 in cash tips which he reports to his employer. (For purposes of this example, assume a minimum wage rate of $7.25 an hour.) Felix's $2 an hour rate is below the $5.15 minimum wage rate (as in effect on Jan. 1, 2007) by $3.15 an hour. Thus, for the 160 hours worked, he is below the minimum rate by $504 (160 × $3.15). For Felix therefore, the first $504 of tip income just brings him up to the minimum rate. The rest of the tip income is $1,496 ($2,000 − $504). Felix's employer pays Social Security taxes at the rate of 7.65% for Felix. The employer's credit is thus $114.44 for the month: $1,496 × 7.65%.

Social security taxes paid with respect to tip income used to determine the credit cannot also be deducted (but you can elect not to take the credit, in which case you can claim the deduction). The credit can be sizeable for the owners of flow-through entities (S-Corps and LLCs). Previous AMT limitations have also been lifted to make the credit more beneficial.

5. REVIEW WAGES, TIPPED EMPLOYEES, AND OTHER EMPLOYMENT LABOR LAWS.

A review of the wages, tipped employees and other employment labor issues would ensure that the business is in compliance with the current labor laws.

Minimum wage, required overtime pay, and restricted child labor. This law is relevant to restaurants since many restaurant employees are often paid minimum wage. The discussion in this section deals primarily with requirements under federal law.

The FLSA states that “no provision of this Act or of any order there under shall excuse noncompliance with any federal or state law or municipal ordinance establishing a minimum wage higher than the minimum wage established in this Act”.

Note that individual states may have more stringent minimum wage laws that must be complied with. For example, In Massachusetts, on June 10, 2004, "An Act Protecting the Wages and Tips of Certain Employees" was signed into law. The Chapter 125 of the Acts of 2004 replaced the existing tip law and made several changes to the enforcement provisions of four wage and hour statutes. The purpose of this advisory is to explain and clarify the provisions of the Act.

In Massachusetts, tipped employees must be paid a minimum of $2.63 per hour provided that with tips, the employee receives at least $8.00 per hour including tips. If the total hourly rate for the employee, including tips does not equal $8.00, then the employer must make up the difference. (Massachusetts Minimum Wage is $8.00 per hour)

Tips and Service Charges. A service charge is a fee imposed on a patron or customer by an employer, as opposed to a discretionary tip or gratuity. The employer, and not the customer, determines the service charge amount. It includes a fee that a "patron or other consumer would reasonably expect to be given to a wait staff employee, service employee or service bartender in lieu of, or in addition to, a tip. Therefore, ambiguously described fees such as a service fee or service surcharge are treated as service charges that must be remitted entirely to wait staff employees, service employees and service bartenders. If an employer chooses to add a service charge to the bill, it must distribute the proceeds in "proportion to the services provided by those employees." Employers may impose an additional fee, or a fee in place of a service charge. This fee may be identified as an administrative, house or other fee and may be retained or distributed by the employer at its discretion. It must be evident to customers that this fee is not a gratuity, tip or service charge.

Massachusetts state law allows a civil penalty for restaurant operators who violate the tip law. Wait Staff, Bartenders are entitled to 100% of the tips.

It's recommended that local labor law requirements be investigated before setting any compensation or other personnel policies.

The following are good sources of information:

- State Labor Department.
- U.S. Department of Labor (DOL) - the DOL maintains district offices that can provide information. Additionally, the DOL website, www.dol.gov, has a summary of the basics of state wage and hour laws.
- The National Restaurant Association - this organization has an online Legal Problem Solver that is free to members. This publication provides answers to many common restaurant problems www.restaurant.org/profitability/support/legal/lps/

Below are two excerpts from fact sheets that may be helpful for quick references:

Fact Sheet #2: Restaurants and Fast Food Establishments Under the Fair Labor Standards Act (FLSA)
This fact sheet provides general information concerning the application of the FLSA to employees of restaurants and fast food establishments. (www.dol.gov)

Fact Sheet #15: Tipped Employees Under the Fair Labor Standards Act (FLSA)
This fact sheet provides general information concerning the application of the FLSA to employees who receive tips. Tipped employees are those who customarily and regularly receive more than $30 a month in tips. Tips actually received by tipped employees may be counted as wages for purposes of the FLSA, but the employer must pay not less than $2.13 an hour in direct wages. (www.dol.gov)

6. REVIEW YOUR STATE FILING REQUIREMENTS AND OTHER ISSUES

Examples of pertinent Massachusetts requirements include:

- **State sales tax on meals - 6.25%**
- **Local option sales tax on meals - .75%**

The Legislature added a new chapter to the Massachusetts General Laws, “Local Option Meals Excise.” Under this chapter, a city or town may impose a local sales tax on the sale of restaurant meals originating within the city or town by a vendor at the rate of .75 percent of the gross receipts of the vendor from the sale of restaurant meals. This local excise, which is imposed in addition to the 6.25% state sales tax on meals, takes effect on the first day of the calendar quarter following thirty days after acceptance by the city or town or on the first day of a later calendar quarter that the city or town may designate.

Further guidance is available at http://www.mass.gov/Ador/docs/dls/publ/bull/2009/2009_15B.pdf.

Mandatory Liquor Liability Insurance. The Legislature enacted a new law requiring restaurants to have liquor liability insurance. A Section 12 license will not be renewed or issued until they file a certificate of insurance with their local licensing authority. The minimum amounts of coverage required will be $250,000 for injury or death to one person and $500,000 for injury or death to more than one person in one accident. A complete summary of the law is provided by the Alcoholic Beverages Control Commission at www.mass.gov/abcc**.**

Sunday Morning Alcohol Sales at 10:00 am. The Massachusetts Legislature passed a new law authorizing local licensing authorities to allow restaurants to begin serving alcohol at 10:00am on Sundays. Licensees were previously restricted from selling before noon or 11am. Each city or town must change their laws in order to "opt in" to the new provision. Once the municipality has accepted the new hours, it must develop a procedure to expand the hours of individual licenses. In some cases, the licensee will need to submit a formal written request to their licensing authority to be granted the expanded hours.

It is important to check with your local licensing authority about their specific protocol before making any changes in the hours you serve alcoholic beverages.

Massachusetts also imposes penalties on restaurants (and other businesses) with eleven or more full time employees that do not provide "fair and reasonable" health coverage. The calculation to determine who falls under this provision is based on total hours and is sometimes onerous.

Massachusetts Health Insurance Mandate and Related Items. With healthcare being a hot topic, in an effort to assist small business in creating jobs across the Massachusetts, Governor Patrick instituted a state program specifically for small businesses struggling with the rising cost of health insurance for their employees. This new small business health insurance program is called Business Express, and was launched by the Massachusetts Health Connector in February 2010 in conjunction with Governor Patrick's small business jobs bill.

Business Express is for small businesses with 50 or fewer employees. There are no membership fees and the administrative costs are reduced, therefore many businesses with five or fewer employees may save more than $300 per employee per year. For more information, visit the Health Connector website www.MAhealthconnector.org.

7. ENSURE YOUR ACCOUNTING SYSTEM IS ORGANIZED AND IMPLEMENTED PROPERLY

If accounting systems are not properly set-up from the on-set, we often see poor utilization of some of the key reporting tools that should help management make informed and important decisions. We strongly recommend that you review periodically your internal control procedures and maximize the output generated by your accounting software. For instance, QuickBooks can assist you in setting up budgets to help you track year-to-year or month to month fluctuations. We often find that there is a direct correlation between a proactively managed business and how well the owner is managing their books. It is very important that management instill a consistent monthly close process. We also recommend that your "Chart of Accounts" be set-up to integrate accounts as instilled by industry standards. In addition, we recommend a variety of benchmarking industry statistics that can help guide you in your day-to-day management of the restaurant.

Often the linking of your point of sale system to the accounting software is vital to completion of timely and accurate monthly closings. If these systems are not integrated, we strongly recommend that you put in place. In addition, if you are not using a point-of-sale system because you feel your sales levels do not warrant it, we recommend that you reconsider a review of the products available under a cost/benefits review.

8. APPLICATION OF KEY ANALYTICS TO YOUR INTERNAL FINANCIAL STATEMENTS.

Typically, 65 – 70% of every dollar in restaurant sales is attributable to food and beverage purchased plus labor costs (wages plus employer paid taxes and benefits). It is these costs that the owner can best control. Through more effective purchasing, menu pricing and product handling you can effectively impact the bottom line. Restaurants become vulnerable when the prime costs exceed 70% of revenue.

A restaurant that caries too much inventory will inevitably have higher food costs. Excess waste, reduced product utilization, and over portioning will often tie-up your liquidity. Full-service restaurants should often have on average no more than 7 days inventory. If you are not aware of these calculations and how to monitor we suggest you strongly consider.

Keep separate costing records of your menu items. Go beyond the simple "other restaurant" comparisons to determine how you determine pricing. Look to gain a better understanding of how to convert product prices from the way you purchase them to recipe units for costing purposes.

9. CONSIDER EMPLOYEE RETIREMENT PLANS OR PROFIT SHARING INCENTIVES TO IMPROVE RETENTION AND BENEFIT OWNERS

The retirement planning and profit sharing landscape have many options for business owners these days. If your restaurant is looking to provide a low cost retention tool for your employees you have many options. Plan options include a SIMPLE, SEP, 401(k) (safe harbor, ROTH integration, etc.), or Defined Benefit arrangements. With minimal company obligation, your restaurant can establish a flexible and user friendly retirement option while affording owners the ability to maximize their own contributions. There are a variety of resources out there that can assist owners to identify and compare the costs of sponsoring a 401(k) plan or similar option. For key employees/management, owners can also consider putting in place a program that rewards bonuses to key employees that impact the bottom line. These programs can be designed in a variety of ways to include such hot buttons as "phantom equity" and performance bonuses based on key financial outcomes.

10. REVIEW LOYALTY PROGRAMS AND SOCIAL MEDIA

More than three-fourths of restaurant operators successfully use some form of customer loyalty program to attract and retain business, according to a National Restaurant Association survey. Restaurants can reinforce branding in the minds of customers with card punch programs, new dish sampling discounts, or similar techniques. Social media plays a large role for many restaurants: 74% of respondents said they connect with customers using some form of social media, including Facebook, Twitter, and blogging. Engaging customers via loyalty programs and social media may help restaurants retain business in the face of increasing competition.

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