Tax reform and the consumer products industry: Key considerations
A look at some favorable and potentially unfavorable provisions

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The tax law changes commonly referred to as the Tax Cuts and Jobs Act (TCJA), signed into law on Dec. 22, 2017, stands to be the most significant overhaul of U.S. tax policy since 1986. With most tax reform provisions already in effect as of the first of the year, it’s crucial that middle market consumer products companies and their owners understand the key provisions that may affect their business operations.

Areas of critical change:
- Corporate tax rate
- Pass-through income tax deduction
- Deferred tax changes
- Manufacturing deduction
- Capital expenditures
- Qualified improvement property
- Net operating loss limitations
- Elimination of alternative minimum tax
- Business interest limitations
- Business entertainment deductions
- Repatriation of earnings
- State income tax deductions
- Estate tax exemptions

Other considerations:
- State responses to federal reform
- Impact on exit strategy and succession planning

While the most noteworthy change may be the reduction of the corporate income tax rate from 35 percent to 21 percent for tax years beginning after Dec. 31, 2017, there are several other provisions that consumer products companies should assess.

Below, we take a brief look at the changes we believe will most affect retailers, food and beverage companies, restaurants, and fashion and home furnishing businesses.

Pass-through income tax deduction: Section 199A of the TCJA provides owners of qualified pass-through businesses the ability to claim a deduction from taxable income of up to 20 percent of qualified business income potentially creating a net effective federal income tax rate to the business owner of 29.6 percent compared to the new top ordinary income tax rate on business owners of 37 percent.

RSM insights: One of the major tax questions arising from the changes to the tax rates is choice of entity. Many middle market retailers, restaurant groups and growers operate as pass-through entities and may be tempted to change entity type. But the decision must take other factors into account. When forecasting the benefits or drawbacks of a potential entity type change, it is important to consider:

- Future M&A transactions. C corporations are still subject to two levels of taxation, and corporations can create more friction in a sale scenario where the buyer wants to buy assets and the seller wants to sell stock if an exit strategy is in the near term.
Buyers generally prefer buying assets over stock in order to write off the purchase price for tax purposes. If a C corporation sells its assets, getting money out of the C corporation requires a dividend which creates a second level of tax such that there could be a federal tax of 39.8 percent on the total transaction rather than potentially a 29.6 percent tax rate when a pass-through business sells its assets.

- **Accumulated earnings tax and the personal holding company tax.**

- **Succession planning.** Are pass-through company owners looking to sell the business to outside investors or keep the business in the family?

  If the company is going to stay in the family and pass through to the next generation, it may be worth considering changing to a C corporation. However, if the business may be sold in the near term then it may be better to remain a pass-through business in order to avoid double taxation which may exist in the C corporation setting.

- **Distribution of earnings.** Do owners of the pass-through entity require cash from the business to be distributed annually?

  The distribution of earnings from a C corporation creates a dividend which would be taxed to the owner, creating an effective tax rate in excess of the pass-through tax rate.

- **Deductions.** C corporations can still deduct state income and property taxes versus the $10,000 cap for individuals.

### Bonus depreciation and qualified improvement property (QIP):

There are new provisions under the TCJA that allow companies to potentially deduct 100 percent of certain capital expenditures on personal property, including acquisitions of used property. Bonus depreciation allows for 100 percent expensing of qualified property through 2022, then phased out through 2026. This is applicable for property acquired after Sept. 27, 2017.

**RSM insights:** Most consumer products companies have extensive capital expenditure spend. The provision enables retailers or restaurants to remodel their spaces, or food and beverage companies to buy new or used equipment for a manufacturing facility, and immediately expense qualified property.

In addition, section 179 allows for expensing of $1 million of additions, with phaseouts beginning at $2.5 million. There may be a planning opportunity for consumer product companies to effectively use section 179 to reduce state income tax in those states which decouple from the bonus depreciation rules, but do allow section 179.

One significant item that was missed in the new tax law which could have a major impact on consumer products companies relates to the provision for QIP. The Protecting Americans from Tax Hikes Act of 2015 made certain interior, nonstructural improvements eligible for bonus depreciation for building owners. In order to qualify for bonus depreciation under TCJA, QIP needs to have a class life of 20 years or less; however, QIP was inadvertently not provided a separate class life in the TCJA apart from real property. It appears Congress intended for QIP to qualify for bonus depreciation, but unless a technical correction occurs to fix this issue QIP will not qualify for bonus depreciation. This will have a major impact on consumer businesses looking to open new locations or expanding and improving current facilities.

Cost segregation studies may become more valuable. Consumer product businesses should consider a cost segregation study to reclassify 39–year life assets to 20 years or shorter. Assets acquired and placed in service after Sept. 27, 2017, may be written off entirely rather than depreciating over 39 years. The TCJA expanded qualified property to include certain used property. That may provide opportunities to expense the shorter-lived property in a real property acquisition that did not exist prior to the TCJA.

### Limit on interest deduction:

The limitation caps net interest deductions at 30 percent of an amount based on an adjusted taxable income figure (similar to EBITDA through 2021, then EBIT thereafter). Limited interest deductions can be carried forward.

**RSM insights:** This is an important provision for consumer products companies, especially those that have been acquired by private equity where debt was used to leverage the business. Private equity groups are concerned about this provision, as are businesses that have used debt to recapitalize and perhaps made distributions to owners. Companies will now need to model out these calculations to determine if interest expense will be fully deductible. Once the cap is based on 30 percent of an EBIT–type amount, interest expense will be limited further than over the next four years as depreciation and amortization will lower the base.
**Net operating loss limitations (NOLs):** A provision in the new tax act reduces the value of NOL carryforwards as net operating losses arising in taxable years beginning after Dec. 31, 2017, can no longer offset all of taxable income in a given year. The newly generated NOLs have an 80 percent limitation. NOLs generated in years prior to 2018 can continue to be used to offset 100 percent of income in a given year. Additionally, new net operating losses generated after 2017 can no longer be carried back to prior years.

**RSM insights:** This is unfavorable for startups in the consumer products industry that may have losses in early years of operations. For example, a retailer who incurs $1 million of tax losses in 2018 and then earns $500,000 in 2019 would only be able to offset 80 percent of the 2019 income and need to pay tax (negative cash flow) on the remaining $100,000 of income in 2019.

**Active business loss limitations apply at the individual level:** For noncorporate taxpayers for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, excess business losses are limited. The provision prohibits deducting excess losses against wage or investment income. The limitation applies even if an owner is active in the business, unlike in the past when there were loss limitations only if the activity was passive. Excess business losses are defined as “the excess of the taxpayer’s aggregate deductions attributable to trades or businesses of the taxpayer over the excess of aggregate gross income plus $250,000.” Disallowed excess business losses are treated as an NOL carryforward, which the new act limits to an 80 percent deduction in future years.

**RSM insights:** This is important to active owners of consumer products companies who have multiple activities or who have wage income which in the past could have been fully offset by pass through K-1 losses from businesses where they were actively engaged. For example, the owner operator of a craft brewery who receives a K-1 with losses in a given year can only use up to $250,000 of a net loss to offset wages, interest, dividends and capital gains and no longer be able to utilize the brewery’s net loss in excess of $250,000 against individual income but rather must carry the excess loss forward as a net operating loss.

**Tax credits preserved:** The FICA tip credit, Work Opportunity Tax Credit (WOTC) and Research and Development (R&D) credits have been preserved.

**RSM insights:** The preservation of these credits is positive for the retail, restaurant, food and beverage, and fashion sectors. Restaurants rely heavily on getting a tax credit for reporting tips received by their employees. The R&D credit is important to the food and beverage companies who may be developing new ingredients and products, as well as fashion companies who are developing new designs.

For both retailers and restaurant operators, the WOTC provides significant bottom-line savings as companies hire eligible employees. These businesses may receive direct tax credits of up to $9,600 for every eligible employee. Business should establish a process for identifying the WOTC-eligibility of new hires within their first 30 days of employment.

**Charitable contribution deductions preserved:** The charitable contribution deduction has been preserved for both cash donations as well as inventory donations.

**RSM insights:** Charitable contribution deductions were preserved including enhanced donation for food inventory. This is especially important to restaurant and food and beverage companies that may donate excess inventory to charities and can receive an enhanced tax benefit.

**Repeal of Domestic Production Activities Deduction (DPAD or Section 199):** In the past, companies received a tax incentive for manufacturing in the United States. This deduction is eliminated for tax years beginning after Dec. 31, 2017.

**RSM insights:** The repeal of DPAD is unfavorable to consumer product manufacturers such as craft brewers, commissaries, food and beverage manufacturers, as well as apparel and footwear manufacturers. However, this lost tax deduction should be offset by the reduction in overall tax rates. Consumer businesses should ensure they fully claim any available DPAD benefit prior to filing their 2017 income tax return.

**Elimination of entertainment expenses:** The TCJA completely eliminates the employer tax deduction for substantially all directly paid or reimbursed business entertainment expenses. Additionally, for amounts paid or incurred after Dec. 31, 2017, the 50 percent limitation has been expanded to include employer expenses associated with providing food and beverages to employees through an eating facility meeting de minimis fringe benefits requirements.
RSM insights: Elimination of tax deductions for entertainment expenses may have a significant impact to consumer products companies, especially the restaurant sector if business meals are considered entertainment for this provision. There continues to be confusion and a lack of clarity as to what “entertainment” means. IRS regulations may be issued that should define “entertainment” more clearly.

Mandatory tax up to 15.5 percent on accumulated foreign earnings: Beginning with the year ended Dec. 31, 2017, companies with earnings and profits offshore are going to have to pay a tax which may be up to 15.5 percent on such earnings.

RSM insights: This provision is important to global consumer products companies. For example, the fashion and home furnishings sector with foreign earnings will be affected by this provision. Although this provision will create a cash outflow for those affected there is the benefit of having this income taxed at a lower than normal federal tax rate. The impact on state taxable income will need to be considered.

Although there is a transition to a territorial system, it’s important to remember that all prior international tax provisions remain in place. Going forward, consumer product businesses should consider restructuring and the additional new provisions on global intangible low taxed income (GILTI) and foreign derived intangible income (FDII). For large corporations (greater than $500 million of gross receipts), the base erosion and anti-abuse tax (BEAT) will affect taxpayers with global supply chains.

Decoupled and Diverse State Response: The state response to federal tax reform will come through piecemeal state legislative action. Most states will be primed to address reform in the 2018 state legislative season.

The size and shape of state reform, and the ultimate response to federal reform, will likely be unclear for at least a year. Some states will need time to observe the revenue impacts to state budgets before taking action. Other states with rolling conformity may act immediately to modify how the state conforms to federal tax changes.

Notwithstanding the uncertain state response, consumer products businesses have plenty to consider now. Most states are either fixed-date or rolling conformity to the Internal Revenue Code (IRC), although many of those states may only conform to selected provisions of the IRC. Taxpayers in fixed-date conformity states may have significant compliance burdens between the federal and state obligations. Rolling conformity states may choose to decouple from provisions that may negatively impact state revenues, such as the enhanced deduction for capital expenditures or the new pass-through deduction.

RSM insights: The uncertain state response to federal tax reform provides a number of opportunities for consumer product businesses including but not limited to the following:

- Maximize credits and incentives benefits associated with increased investment, job creation, planning, repatriation events
- Transaction planning and mergers and acquisition activity generally
- Structural planning and choice of entity considerations impacting state taxation
- Effective tax rate planning—domestic and worldwide footprint analysis
- Identifying cross-border transactions to analyze impact, including repatriation of foreign earnings
- Fixed asset purchase optimization
- Personal and business domiciliary planning
- Pass-through entity treatment, methodology and changes
- Interest expense limitations and taxes on related party transactions
- IRC conformity and state legislative responses
- Sales and use tax opportunities

There are numerous layers to each affected provision of the new tax reform. Leaders of consumer products businesses, in particular, have many nuanced areas to consider and must assess the impact of tax reform within the specific fact patterns of the business. It is always important to look beyond the initial highs or lows of regulatory change and inspect it with a business-first approach. This means bringing together finance, tax and operations leaders to analyze each provision and craft an appropriate, custom response for the business.
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