INSIGHTS FROM THE BDO RETAIL & CONSUMER PRODUCTS PRACTICE

TAX REFORM FAQ FOR RETAIL & CONSUMER PRODUCT COMPANIES

By Scott Ziemer

The $1.5 trillion tax reform legislation known as the "Tax Cuts and Jobs Act" (TCJA) represents the biggest change to the tax code since 1986. While the business implications are broad and complex, we've summarized some of the most commonly asked tax reform questions relevant to retail and consumer product companies:

How will the reduction in the corporate tax rate affect retailers?

The drop in the corporate tax rate is great news for retailers. Historically, corporate taxable income is subject to tax under a four-step graduated rate structure, with the top corporate tax rate of 35 percent on taxable income in excess of $10 million. Now, the new corporate tax rate will stand at 21 percent. Retailers will use this increased cash flow to invest more in employees and to update existing stores. For publicly held companies, some of this cash will be used to buyback shares of stock or possibly pay out special dividends.

In terms of employee benefits, some companies have increased employee compensation across all levels, while other companies are more strategically targeting certain employee positions to decrease turnover.

Other retailers have indicated that this cash flow will not be used to increase previously planned store openings for two separate reasons. The first is that many retailers are still reviewing the profitability of their existing stores. Second, even growing retailers have a limited capacity on the number of stores that they can support internally to ensure successful openings. However, many retailers have indicated plans to remodel existing stores over the next few years.

Finally, a number of retailers have announced that they will be using the cash to buy back their stock. Some Wall Street analysts are speculating that some of these retailers may also announce special dividends to shareholders within the next 12 months.

With the TCJA requiring companies to write off research expenses over a longer period of time, how will retailers adjust their research and development expenditures?

In the past, retailers could immediately deduct software development expenditures. Starting in 2022, they must amortize research expenses over five years. Previously, for example, installing a new pricing system costing $7 million would warrant an immediate $7 million deduction. After 2021, this deduction will be spread over five years. Retailers may accelerate certain software projects that are planned to take place after 2021. Further, retailers with major software development projects should revisit the R&D credit.

How will the new limitation on interest deductibility affect retailers' interest expenses?

The TCJA revises Section 163(j) and expands its applicability to every business, including partnerships. This new provision generally limits the interest deduction to the sum of interest income and 30 percent of EBITDA for years 2018 to 2021. In 2022 and years after, the deduction will generally be limited to the sum of net interest income and 30 percent of EBIT. The interest expense that is disallowed is carried forward indefinitely until the time it can be deducted.

This provision will cause retailers with a high level of debt, often used for fund operations and expansions, to possibly defer the interest expense deduction, resulting in a larger tax bill and

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a further restriction to cash flow. Since existing capital/debt structures are not grandfathered into the new rules, retailers should revisit their current financing structure and expansion plans to possibly get more appropriate funding and reconsider the proposed expansion.

The TCJA repeals the Domestic Production Activities Deduction (DPAD or Section 199). How will consumer product and retail manufacturers react?

The DPAD was a tax incentive for businesses that manufactured property, at least partially, within the United States. Consumer product manufacturers that previously claimed the section 199 deduction will no longer be able to reduce their tax rate by using this benefit. However, this impact will likely be offset by the significant reduction in overall tax rates. Retailers that engage in a manufacturing activity such as food prep or chemical mixing will lose the rate benefit of performing this activity.

How will retailers adapt to the TCJA's elimination of carryback for net operating losses?

This change will generally eliminate retailers' abilities to carryback net operating losses (NOLs) and will limit the use of NOLs generated after 2017 to 80 percent of taxable income. However, NOLs will no longer have an expiration period.

This change will prevent retailers in loss years from being able to file a carryback claim to get back taxes paid in the previous two years. The loss of this benefit will restrict cash flow when retailers need it most.

The 80-percent limitation will also cause companies without significant pre-2018 losses to possibly pay tax in years after a significant loss. Losses incurred in one year will not be able to offset 100 percent of taxable income in the next year

In situations where retailers' earnings are volatile, the restrictions on the carryback and use of NOLs presents a significant cash flow obstacle.

Which international provisions will most affect retailers?

The Transition Tax on Existing Overseas Profits imposes a one-time tax on U.S. shareholders on the accumulated, untaxed earnings and profits of controlled foreign corporations (CFCs) and certain foreign corporations wherein a domestic corporation owns at least 10 percent, at a rate of 15.5 percent on the foreign corporations' earnings held in cash and cash equivalent assets, as well as an eight percent rate on earnings attributable to non-cash assets, regardless of whether the amounts are actually distributed.

This measure is designed to raise tax revenue from income that has not previously been subject to U.S. taxation. But it's also meant to entice companies to invest some of their foreign profits stateside.

Other International provisions that may affect retailers with international operations is the tax on Global Intangible Low-Taxed Income and the Base Erosion and Anti-Abuse Tax.

Are there any accounting method implications from tax reform?

Tax reform has provided an opportunity to use accounting method planning opportunities that can result in permanent tax savings for taxpayers. See BDO's **Summary of Key Tax Reform Implications on Accounting Methods** alert for an overall analysis.

As many of these planning ideas can only be implemented in a limited time frame, retailers and tax professionals are encouraged to begin gathering information and evaluating action items as soon as possible to properly comply with the procedural rules for making accounting method changes.

What are the longer-term effects of tax reform for the retail industry?

Despite some exceptions, many retailers anticipate tax reform will have a positive long-term effect on the industry. Lower tax rates, along with changes to bonus depreciation, will provide many companies the capital they need to invest in improvements, hiring and retention, expansion, acquisitions, and more. While it's impossible to fully predict the new law's long-term effects, there's no doubt that the tax code changes will significantly impact retailers.

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CONTACT

SCOTT ZIEMER
Tax Office Managing Partner
602-293-2530 / sziemer@bdo.com