

PUBLICATION

How Franchisors Can Benefit from the Qualified Business Income Deduction

Authors: Thomas J. Mahoney, Jr., Allen Brooks Blow, Joel Buckberg
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Many franchisors and franchisees operate for tax purposes in pass-through entities (LLCs, S corporations, partnerships, and entities that are disregarded for tax purposes). The owners of pass-through entities pay tax at individual tax rates on income that is earned by the pass-through entity.

The Tax Cuts and Jobs Act of 2017 sharply decreased the corporate tax rate paid by corporations. In order to also benefit businesses operated in pass-through tax entities, the Act introduced the concept of the Qualified Business Income (QBI) Deduction. The QBI Deduction generally reduces the differential tax rate paid by corporations as compared to the rate paid by owners of pass-through entities by allowing the owners of pass-through entities to deduct up to 20 percent of their QBI. The QBI Deduction has many limitations and complexities associated with it. The IRS has recently announced regulations and related guidance that clarifies the availability of the QBI Deduction, which will be beneficial to pass-through entities involved in franchise businesses.

Franchisors Can Qualify for the QBI Deduction

The new final regulations include an example which makes it clear that a franchisor engaged in the business of franchising a brand will be entitled to use the QBI Deduction even if its franchisees are in a business (a "specified service trade or business" or SSTB) that may not be able to use the QBI Deduction. An SSTB is a trade or business: (1) that involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners; or (2) that consists of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. The final regulations take a relatively narrow view of the Reputation or Skill Clause. Under the regulations, the Reputation or Skill Clause will only apply to a trade or business consisting of any of the following activities: (A) receiving fees, compensation, or other income for endorsing products or services; (B) licensing or receiving fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; or (C) receiving fees, compensation, or other income for appearing at an event, on radio or television, or in another media format.

Prior to the new regulations it was uncertain, for example, whether a franchisor's business of franchising a financial planning brand would constitute an SSTB if the franchisee's operation of such financial planning business would likely constitute an SSTB. The regulations make clear that such a franchisor will not be considered in an SSTB and therefore will be able to benefit from the QBI Deduction.

Application to Franchised Businesses Generally

Only a relatively small number of franchised businesses are likely to be subject to the SSTB restrictions on the QBI Deduction. Therefore, subject to its generally applicable limitations, the QBI Deduction will benefit many franchised businesses that operate in pass-through entities and provide goods and services to the public or other businesses. For example, in a system with company stores/units, the income from those businesses qualifies for the QBI Deduction. The same is true for a supply chain subsidiary that manufactures and sells tangible products to franchises, and for the revenue stream that the franchisor receives from the sale of

tangible personal property to franchisees. Revenue streams representing franchise fees and services fees, such as marketing fund contributions, reservation fees, technology fees, marketing-related fees, and the like also are generally eligible for the QBI Deduction to the extent they generate taxable income for the franchisor.

The QBI Deduction is subject to limitations and qualifications not discussed in this alert. Please remember that advice and counsel regarding your particular tax-related issues, including the potential impact and application of the developments outlined above, are dependent on your specific facts and circumstances. For more information about how these issues may affect you, your business, or related matters, contact the co-authors of this alert, [Tom Mahoney](#), [Allen Blow](#), [Joel Buckberg](#), or any member of Baker Donelson's [Tax Group](#).