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June 9, 2018

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Ave, NW
Washington, DC 20020

Re: Initial comments on the meaning of the term "specified service trade or business" under section 199A(d)(2)

Dear Assistant Secretary Kautter:

Enclosed pleased find comments on behalf of the International Franchise Association ("IFA") regarding the definition of a "specified service trade or business" ("SSTB") under section 199A(d)(2) of the Internal Revenue Code. Specifically, the comments address why the business of franchising should not be considered to meet the definition of an SSTB.

IFA would be pleased to discuss these comments with you or your staff at your convenience.

Sincerely,

Matt Haller
Senior Vice President of Government
Relations & Public Affairs
International Franchise Association

Enclosure

cc: Thomas West, Tax Legislative Counsel, Department of the Treasury

The Business of Franchising Is Not a "Specified Service Trade or Business" Under Section 199A(d)(2)

I. The International Franchise Association and Its Support of Franchising

- The International Franchise Association ("IFA") is the world's oldest and largest organization representing franchising worldwide. IFA works to promote the interests of nearly 733,000 franchise establishments in the United States. These establishments support close to 7.6 million direct jobs, as well as $674.3 billion of economic output for the U.S. economy and 2.5 percent of the nation's GDP. Since the economic recovery began in 2011, over one in ten jobs created in the United States have been associated with franchising. IFA's members include over 1,400 franchisors in 100 unique business categories plus a myriad of individual franchisees and related companies throughout the country.

- IFA seeks guidance from the Treasury with respect to new section 199A as enacted in the Tax Cuts and Jobs Act.[1] In particular, guidance is needed to determine whether the business of franchising meets the definition of a specified service trade or business ("SSTB") under section 199A(d)(2). Income derived from an SSTB generally will not be eligible for the section 199A deduction.[2]

- For the reasons summarized below, the Treasury guidance should provide that franchising does not fall within the SSTB definition. The points below are a preliminary statement of IFA's position on the matter, which it may decide to refine following proposed regulations from the Treasury and the IRS or other developments.

II. Background on the Franchising Business Model

- Franchising covers a broad spectrum of distribution relationships, but the majority fall into the "business format" category. These involve a license from the franchisor to the franchisee for the development of a business, an operating system for the business, and a trade identity under which the business will operate. In a business format franchise network, the structural emphasis is on maintaining the specifications, standards, and operating procedures that are essential to the establishment and operation of a business reflecting the franchisor's format, system, and quality of service standards.

- To this end, the heart of the franchising business model is governed by the federal Lanham (Trademark) Act. The Lanham Act, the primary federal trademark

[1] All section references are to the Internal Revenue Code of 1986, as amended.

[2] *See* section 199A(d)(1)(A).

statute in the United States, allows trademarks and service marks to be licensed and protected. Because of the Lanham Act, and its requirement that licensors police the use of their intellectual property licensed to third parties, franchisors have the right and the obligation to determine how their marks are used, and to do so in a way that protects the consuming public. The essential elements of brand standards and controls were carried over into the rules promulgated by the Federal Trade Commission ("FTC") when that agency began to define and regulate franchising in 1979. Combined with the Lanham Act, the FTC Franchise Rule enabled small independent businesses to grow as part of a brand experience shared with other franchisees in a network.

- In sum, the value of a franchise is in the franchisor's brand plus the franchisor's ability under the law to protect that brand's use through applicable licensing arrangements.

III. The Statutory Language

- Under section 199A(d)(2)(A), an SSTB, with a few exceptions not relevant here, means any trade or business described in section 1202(e)(3)(A). That section, in relevant part, refers to "any trade or business *involving* the performance of services" in certain listed fields, several of which are often the subject of franchising (emphasis added).[3]

- The word "involving" is ambiguous. It is not clear from the word itself whether franchising a service brand in one of the listed fields, say health services, is itself a business "involving" the performance of services in that field. "Involving" on its face could be interpreted as referring to any number of relationships between the relevant business and the relevant services, ranging from a circumstance where the business performs those services directly as the sole and total purpose of its business to a circumstance where the business in some way or other, tangential as it might be, relates to the services performed. However, as discussed below, the legislative history of section 199A provides significant guidance with respect to the degree to which a business must be "involved" with the performance of a listed service before it should be considered an SSTB.

[3] Section 1202(e)(3)(A) refers to "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, 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 1 or more of its employees." In defining an SSTB, section 199A(d)(2)(A) modifies this list to (1) exclude engineering and architecture businesses, and (2) substitute "employees or owners" for "employees." Under section 199A(d)(2)(B), businesses that involve the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) are also SSTBs.

IV. The Legislative History

- IFA believes there are two basic fact situations the Treasury must address regarding the extent of this required "involvement." As will be discussed, both fact situations are highly relevant to determining whether franchising businesses should be regarded as SSTBs, and both are pointedly addressed in section 199A's legislative history. The first is where the business in question does not constitute the typical case of a business in which the service in question is performed. The Treasury's guidance should address the matter of how closely the business must resemble that typical case in order to be considered an SSTB. The second, often closely related to the first, is where the service in question can be said to be an *input* into the typical performance of the listed service. Again, the Treasury guidance should specifically address the question of whether a business that, for example, *facilitates* or *promotes* the performance of a service should be treated the same as a business that actually *performs* the service. We respectfully submit that the legislative history associated with the SSTB definition should play a critical role in the Treasury's determinations on these matters. When applied to both fact situations, we believe the legislative history makes clear that "SSTB" should be interpreted very narrowly.

- Specifically, a series of three footnotes in the Tax Cuts and Jobs Act Conference Report provides the principal basis for this conclusion. These footnotes, which are attached to this paper, are part of the Conference Report's discussion of the Senate version of section 199A, on which the enacted law is based. All of the footnotes discuss section 448, a section that relates to when businesses may use the cash method of accounting. That section precludes use of the cash method by C corporations as a general rule, but provides as one of the exceptions to the rule that the method may be used by a "qualified personal service corporation."[4] It then provides a list of services that are relevant for determining when a C corporation meets the "qualified personal service corporation" definition – a list that closely resembles the new section 199A SSTB list.[5] The clear implication of the Conference Report is that when terms like "health," "performing arts," and "consulting" are assigned a particular meaning by section 448 and its implementing regulations, they should be assigned the same meaning under section 199A.

- Admittedly, the section 448 list serves a very different purpose from that of the section 199A list. Most significantly, it establishes a test for when a given business may elect to *receive* a tax benefit, rather than a test for when that business must be *denied* a tax benefit. It may be argued, therefore, that these purposes are so different that it would be inappropriate for Treasury regulations to require treatment of a business under section 199A to depend on its treatment

[4] Section 448(b)(2); Treas. Reg. § 1.448-1T(e)(1).

[5] Section 448(d)(2)(A); Treas. Reg. § 1.448-1T(e)(4).

under section 448. Yet, the Conference Report makes clear that this is exactly what is expected under the new law. It is difficult to read the footnotes in question as conveying any other message.

- IFA believes that two significant instructions relevant to the treatment of franchisors under section 199A should be taken from these footnotes. Notably, the instructions correspond to the two fact situations mentioned above.

    - First, the services listed in the section 199A "specified service trade or business" definition should be viewed as, for want of better terms, "core," "classic case," "mainstream," or "typical" instances of those services. All three footnotes suggest that if the interpreter of the statute needs to ask whether a particular service is included within the meaning of "health," "performing arts," or "consulting" services, the answer very likely will be that it is not. Under the footnotes, the performance of services in the field of performing arts does not include the performance of services by persons who are not themselves performing artists, even if the services are provided by persons in a business that "relates to the performing arts."[6] (Of note, this reference indicates quite clearly that "involving" should not be viewed as merely "relating to" a listed service.) Further, under the footnotes the performance of services in the field of consulting is confined to the provision of advice and counsel. If such advice and counsel is given in connection with brokerage services or economically similar services, it apparently no longer constitutes the performance of services in the field of consulting.[7] The performance of services in the field of health is limited to services performed by medical professionals. It does not include the operation of health clubs or health spas or other services not directly related to a medical field.[8] Taken together, the footnotes indicate that in ambiguous cases, the statutory terms in question are to be given a narrow interpretation. No activity that does not adhere closely to the classic case of a listed service should be considered to provide the basis for an SSTB determination. Significantly, there is no indication of a contrary instruction anywhere else in the Conference Report.

    - Against this background, it is hard to imagine that Congress would ever have intended a business in which a franchisor sells, say, healthcare service franchises to be treated as an SSTB. The franchisor's activities in that circumstance are just too far removed from the classic case of the actual performance of services by a professional healthcare provider. The franchisor typically negotiates and provides a franchising agreement,

[6] H. Rep. 115-446 (2017), at 216 n.45. *See* Treas. Reg. § 1.448-1T(e)(4)(iii).

[7] H. Rep. 115-446 (2017), at 216 n.46. *See* Treas. Reg. § 1.448-1T(e)(4)(iv).

[8] H. Rep. 115-446 (2017), at 216 n.44. *See* Treas. Reg. § 1.448-1T(e)(4)(ii).

which, as noted, is primarily a license authorizing the franchisee to use the franchisor's trademarks, brands, etc. It also may provide short-term training at the beginning of the franchising relationship for the purpose of protecting the franchised brand.[9] The healthcare franchisor's business can typically be said to "relate to" the field of health, but the critical footnote regarding the term "relating to" makes clear that this is not enough to make it an SSTB.[10] By any reasonable interpretation of this congressional instruction, such a business is not an SSTB.

- In the second instruction, the Conference Report footnotes draw a line with respect to activities that are reasonably viewed as *inputs* into services, *i.e.*, typically, activities that can be viewed as making the service more effective, more attainable, or, in some other way, better. The congressional guidance provided relates to when an input into a listed service should be treated as *part* of that service and therefore as a listed service itself. Footnote 45, which relates to performing arts services and concentrates on this input issue, should be viewed as the principal source of guidance here. Again, the instruction provided serves to restrict severely the circumstances in which an SSTB designation might be considered appropriate for a particular input service. The footnote discusses such supporting or ancillary services as the management and promotion of performing artists and the broadcasting and dissemination of their work. In each case, the footnote provides that a business that performs such input services should not as a result be considered an SSTB.

- Again, the implications for franchising are clear. To the extent there is a service involved in the franchising business model, that service is most readily viewed as a supporting or ancillary service that furthers and facilitates other more basic services, such as those listed in sections 448 and 199A. If that is not enough to support an SSTB designation for other businesses that perform such ancillary services, it is hard to see why it should be enough in the case of franchisors.

V. Public Policy Considerations

- IFA believes that in addition to the legislative history just discussed, two separate public policy arguments support its position.

- First, in determining the reach of the SSTB definition, it is reasonable to ask what Congress was seeking to achieve in excluding SSTBs from the benefits of the

[9] It is worth noting, however, that franchisors have significantly cut back on the supportive assistance they provide to franchisees in light of legal uncertainties with respect to expanded joint employer liability.

[10] *See* note 6, *supra*.

pass-through tax deduction. While a specific answer to that question cannot be found in section 199A or its legislative history, such an answer can be inferred from formal and informal statements of key decision-makers. Congress wished to provide reasonably comparable treatment for C corporations and pass-through entities, but wished to do so without creating opportunities for abuse. The abuse of greatest concern was probably the use of the new pass-through regime to reduce taxes on compensation for taxpayer services. For example, one could imagine service employees of a given company terminating their employment status and instead forming a limited liability company engaged by the former employer to perform the same services the employees used to perform for the employer. The sole purpose of such a restructuring would be to obtain the section 199A deduction for the former employees for what is in substance compensation income.

- The practice of franchising does not create an opportunity for such abuse. If a company decides to perform its operations under franchise – rather than with the assistance of a limited liability service company, as under the above example – the situation is distinguishable in a number of respects. The franchisee will obtain a license for the use of the franchisor's intellectual property and will pay royalties for that use. There will be no payment for services that were formerly performed in-house and no disguising of what is in substance compensation income. Moreover, the franchising arrangement no doubt will have economic consequences going far beyond the kind of tax consequences associated with the example. The step of establishing a franchise cannot be taken casually for tax reasons alone. It is expensive to establish a franchise, and compliance with FTC franchising rules and related state requirements is by any measure demanding. In short, the concerns about abuse that prompted the SSTB provision are simply not applicable to franchising. There thus appears to be no reason at all for imposing the limitations of that provision on the franchising industry.

- Beyond that, as noted above, franchised businesses are a significant driver of the U.S. economy and creator of U.S. jobs. Franchisors, in effect, leverage their investments in their businesses through franchising agreements, a practice that can typically be counted on to create more jobs and economic activity. Given the emphasis in section 199A on job creation and economic growth, and the track record of the franchising business model to date in promoting those objectives,[11] it is hard to see any advantage to the nation in weakening franchising through burdensome tax consequences. That is especially so where, as here, such consequences would be directly at odds with the intent of Congress.

[11] As noted, the franchising model supports close to 7.6 million direct jobs, and is responsible for 2.5 percent of the GDP. Further, the franchising model has been a significant contributor to the most recent economic recovery.

Attachment
Footnotes from Conference Report (H. Rep. 115-446 (2017), at 216 nn.44-46).

- **Text**: A specified service trade or business means any trade or business involving the performance of services in the fields of health,[44] law, engineering, architecture, accounting, actuarial science, performing arts,[45] consulting,[46] athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and 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.

- **Footnote 44**: A similar list of service trades or business is provided in section 448(d)(2)(A) and Treas. Reg. sec. 1.448-1T(e)(4)(i). For purposes of section 448, Treasury regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. See Treas. Reg. sec. 1.448- 1T(e)(4)(ii).

- **Footnote 45**: For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performance of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). See Treas. Reg. sec. 1.448-1T(e)(4)(iii).

- **Footnote 46**: For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect). See Treas. Reg. sec. 1.448-1T(e)(4)(iv).