Research

Potential Investment Held Hostage by the Joint Employer Rule

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The Tax Cuts and Jobs Act (TCJA) enacted in 2017 included significant reforms to the tax treatment of business income. Conspicuous among these changes was a substantial reduction in the corporate tax rate, expanded expensing of qualified property, and a new deduction for qualified business income of pass-through entities. The net effect of these reforms is to reduce the tax burden on investment in the United States. The business tax changes are the most pro-growth elements of the TCJA and could contribute an estimated 2.6 percent increase in long-term gross domestic product (GDP).[1]

Not all businesses, however, are equally situated to take advantage of the new tax environment. Franchise owners, for example, have witnessed three 180-degree flips by the National Labor Relations Board (NLRB) regarding the joint employer standard since 2015. The NLRB broadened the standard in 2015, rescinded that decision at the end of 2017, and most recently vacated the 2017 decision and returned the joint employer standard to the broader definition established in 2015.

These decisions have major implications for franchises. The current broader joint employer standard means that franchisors (such as McDonalds USA) could be held jointly responsible for the employment and pay decisions of independent franchisees. This threatens the franchise business model, as franchisors have less incentive to sell licenses to independent owners and will be less likely to provide franchisees with logistical support. The combination of these factors means that the broader joint employer standard is a major threat to American workers. Previously, the American Action Forum (AAF) found that the broad joint employer standard could cost up to 1.7 million U.S. franchise jobs.[2] In addition, within just one year of the 2015 decision, the broad standard appears to have significantly hampered industries that rely on franchises. In particular, AAF found that hotel franchise job growth declined substantially and drove a decline in total hotel industry job growth. In addition, hotel wage growth stalled and work hours contracted.[3]

The continually changing joint employer standard may also limit the pro-growth benefits of the TCJA. In particular, until the circumstances in which a "joint employer" is recognized are settled, it is difficult to imagine the franchise sector will utilize the new tax law to expand rapidly.

To quantify the potential risk posed by the uncertainty of the joint employer rule to franchises, we estimate the potential tax savings from the TCJA to franchises and posit that some of these savings will not be invested due to the risk posed by the regulatory environment.

To estimate these savings, we calculate a proxy for the business income subject to tax, and in turn the tax savings from the TCJA on that income. For the purposes of this calculation, we begin with the GDP contribution of franchise business and subtract payrolls in 2016.[4]

$ Billions	Payroll	Output	GDP	Net Income	Establishments

Franchisor Owned	54.9	129.8	78.3	23.4	88,487
Franchisee Owned	215	544.5	326.3	111.3	644,355
Total	269.9	674.3	404.6	134.7	732,842

We then estimate the potential tax savings by applying estimated change in effective tax rates for corporate and non-corporate business income due to the TCJA. We concede that this is an imperfect estimate of the potential savings to franchises, which represent a diverse array of industries, capital structures, and other considerations. However, applying average effective tax rate changes to this income would provide a reasonable estimate for expected savings. It is important to note that not all franchise income is treated identically for tax purposes. Indeed, according to the International Franchise Association, 58 percent of franchisees and 39 percent of franchisors file as pass-through entities.[5] The balance of firms are assumed to file taxes as corporations. Accordingly, we assume a similar apportionment of income for the purposes of the tax calculation.

To calculate the change in the appropriate effective tax rates, we rely on a number of studies to inform our views.[6] For the purposes of this calculation we assume that the TCJA reduced effective corporate tax rates by 12 percentage points for 2018 – largely reflecting the combination of the sharp reduction in corporate tax rates and expanded expensing.[7] For pass-through businesses we assume the TCJA reduced effective rates by 6.9 percentage points.[8]

Based on these tax changes, we estimate that the TCJA provided franchised businesses with $12 billion in savings, based on 2016 estimated income. Assuming these savings grow at the rate of projected GDP, these savings would amount to over $140 billion over the next 10 years.

The $140 billion estimate identifies the stakes for reversing the Obama-era decision on the joint employer rule and the timeliness of settling the uncertainty in the franchise sector—whether through legislation or via the NLRB.

[1] https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/

[2] https://www.americanactionforum.org/research/nlrbs-new-joint-employer-standard-unions-franchise-business-model/

[3] https://www.americanactionforum.org/research/trends-hotel-employment-hours-wages-since-nlrb-broadened-joint-employer-standard/

[4] https://www.franchise.org/sites/default/files/Economic%20Impact%20of%20Franchised%20Businesses_Vol%20IV_201

[5] https://www.franchise.org/sites/default/files/Tax%20Reform%20Recommendations.pdf

[6] See: https://www.cbo.gov/sites/default/files/113th-congress-2013-2014/reports/49817-taxingcapitalincome0.pdf; http://www.aei.org/wp-content/uploads/2011/10/20080206_0122698TaxPolicyg.pdf; http://budgetmodel.wharton.upenn.edu/issues/2017/12/15/effective-tax-rates-by-industry;

[7] http://budgetmodel.wharton.upenn.edu/issues/2017/12/15/effective-tax-rates-by-industry

[8] Based on https://www.cbo.gov/sites/default/files/113th-congress-2013-2014/reports/49817-taxingcapitalincome0.pdf and author’s calculations