TRANSFER OF A FRANCHISE

How to Develop the Best Practices In Succession Planning for Franchisees

By Bruce S. Schaeffer

This article focuses on the issues involved in succession planning for franchisees so that franchise systems may develop the best practices to deal with the issue. The purpose of succession planning is to foster the economic benefit of the entire franchise system and the economic interest of the franchisees. Although, in some instances, the interests of the franchisor and franchisee are not the same, the best practice, by far, is for the franchisee to seek the approval of the franchisor, and for the franchisor to accommodate the franchisee's concerns without sacrificing the principles of the franchise system.

From the franchisee's point of view, the key problems that need to be addressed are (1) certainty of transfer, especially in the case of accidental death; (2) economic benefit of the franchise vs. control responsibility (how can a typical franchisee benefit all his or her children if only one child is an authorized transferee?); and (3) valuation for estate tax purposes—an area where all the necessary planning information is available to the franchisor, but not, usually, the franchisee.

The key to any successful solution to these issues, clearly, is to plan in advance. Successful succession planning for a franchisee requires the cooperation (to the best extent possible) of the franchisor and franchisee, because they both seek to accomplish a seamless transfer that (1) maintains the value of the franchise for the franchisee and (2) maintains the royalty stream and good will of the franchise for the franchisor.

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Succession Planning in General

Succession planning for franchisees is the legal, financial and tax analysis that goes into arranging the transfer of a franchise, whether by (1) sale or exchange, or (2) gift, bequest or devise. In many respects, a franchise is a unique asset, and succession planning using techniques developed for other types of assets may not be viable. Sound planning requires considerable input from the franchisor as well as from the more traditional estate planners, accountants and attorneys.

A hard-working franchisee, following the franchisor's methods religiously, can build his or her operation into a successful business—a valuable asset. However, because of the protections for the franchisor, and franchisee restrictions customarily found in a franchise agreement, evolving a sensible estate plan for a franchise owner is far more difficult than for the old-fashioned sole proprietorship or closely held business.

Estate planning for a franchisee requires an initial focus on the devise or transfer itself. Only after clearing that hurdle can the franchisee turn his or her remaining attention to the tax issues at hand.

The major issues raised with succession planning for a franchisee are:

- Restrictions on the transfer of the franchise imposed by the franchise agreement;
- Valuation problems with respect to the "franchise," which is, effectively, a contract right for tax purposes; and
- Miscellaneous problems such as potential income tax liabilities of the decedent for reasonable compensation or accumulated earnings tax or the availability of special tax code provision § 6166 to defer the payment of estate taxes to take advantage of lower-interest rates, or § 2057 to reduce the amount.

Restrictions on Transfer: Certainty of Transfer

Most franchise agreements have a section concerning renewal, termination, repurchase, modification and assignment of the franchise. These are contract restrictions on the franchisee's right to freely transfer the franchise. These contract limitations are sometimes the subject of separate state legislation.

The International Franchise Association, in its Franchise Opportunities Guide, cautions prospective franchisees to look at such restrictions carefully before buying a franchise, as follows:

> Is the franchisee permitted to transfer interests in the franchise? What conditions or restrictions are placed on transfers of the franchise and of majority or minority ownership interests in the franchise? Does the franchisor have a right of first refusal with respect to proposed transfers, and if so, what types of transfers does it apply to (e.g., majority ownership interests or sale of business, transfers to family members or among existing owners)?

A sample provision from a franchise agreement reads as follows:

> Neither Franchisee's interest in the Franchise Agreement, nor any of his rights or privileges thereunder, nor the franchised business or any interest therein, may be assigned, transferred, shared or divided, voluntarily or involuntarily, directly or indirectly, by operation of law or otherwise, in any manner, without first...obtaining Franchisor's approval.

This standard restriction that franchisors impose enables them to enforce their high-quality standards and to ensure uniformity within their systems. Failure to comply with

Continued on Page 4

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Succession Planning

Continued from Page 3

these restrictions generally becomes cause for termination of the agreement. Thus, a franchisee trying to go against the franchisor's demands may well end up with no franchise at all.

To develop a succession plan for a franchisee, the specifics of the franchise agreement must be carefully reviewed. The franchisee may not be aware of some of the terms that may be restrictive. A franchisee must know about these terms before devising and paying for a succession plan.

For the benefit of the franchisee and the franchise system, the franchisees should be advised about the restrictions so that they are aware before they sell (or die, giving rise to estate tax valuation problems)—when it is too late to plan.

A key issue that should be addressed is that of transfer in the case of accidental death. The best practice is for the franchise system to provide its franchisees with information about the mechanics of transfer, and particularly to arrange for a sudden death or simultaneous death (i.e., husband and wife) transfer.

Permission to Transfer

As a simple rule, a franchisee developing a succession plan should contact the franchisor's legal department before going forward and devising an estate or succession plan. Otherwise, the plan developed may appear to do wonders for the franchisee but be unacceptable to the franchisor. For example, some franchisors have definite antagonism toward any franchise having more than one owner.

An example: Max Landers owns four Super Duper franchises to operate fast-food stores. He is 62 years of age, has had a heart bypass operation and is uninsurable. Landers and his wife, Roseanne, both graduated from Super D University. Mr. Landers has six children. Three of them graduated from Super D University and are therefore qualified owner-operators. The problem: How does Mr. Landers structure an estate plan so that he leaves the greatest economic benefit of his four Super Duper stores first to his wife, and the remainder to his six children equally?

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Franchise systems have evolved restrictions not because they are cruel or belligerent, but because such systems are successful businesses that learn from their mistakes. A franchise system that found that a substantial number of its operations owned by sibling partners ended up in litigation between the partners, causing the franchise operation to suffer (and thus diminishing their royalty receipts), is loath to condone any such form of plural ownership of its franchises. Therefore, several franchisors have concluded that more than one owner will be allowed only in the husband-and-wife context—no siblings and no unrelated partners. Of course, this is not always the case. Many franchisors do allow plural ownership, or at least minority ownership. In many agreements, it is required that the owner-operator maintain "control" or devote substantially all his or her time to the franchised business.

Rarely will a franchisor prevent a sale to a qualified outsider, but sometimes franchisors will not allow a devise to a partnership of working siblings. Sometimes the best succession plan is a pre-death sale. This offers none of the income tax benefits of a stepped-up basis for income tax purposes, which are available to children in a normal devise.

So, another key issue that must be addressed is whether the desired transferees will be acceptable to the franchisor. The best practice is for the franchise system to provide its franchisees with all the information about who are permitted transferees.

It is in this context that the issue of economic benefit vs. control responsibility comes up. Where the franchisee has more children than franchises, there is often a conflict between the desire to benefit all children and the franchisor's concern about plural ownership. When there is a conflict, the best practice would be to work together to accomplish the desires of both.

Valuation

For franchisees with substantial net worths, the estate tax is a principal consideration in developing the succession plan. The Internal Revenue Code generally requires the estate tax to be imposed on the fair market value of the estate of the deceased at the time of his or her death. See also Rev. Rul. 59-60 1959-1 C.B. 237. Franchises present unique problems in the area of valuation. In the case of a forced sale, the value of the franchise, in theory, would be depressed. That is a major reason for preparing a succession plan.

Valuation Methods

There are three basic methods of valuation that are accepted by the courts and the IRS. They are (1) book value or net worth, (2) capitalization of earnings, and (3) comparable sales. The most persuasive, when available, is comparable sales.

As a general rule, all the information on comparable sales of franchise units is in the possession of the franchisor. The best practice is for the franchise system to provide its franchisees with all the information it can about comparable sales without divulging confidential information.

Valuation Discounts

Valuation is important to the franchisees, simplistically, to determine the value of their franchise(s), but also because court decisions allow for valuation discounts that can be astonishing tools for tax savings.

Primarily, the courts have allowed discounts for (1) lack of marketability (i.e., the restrictions on transfer), and (2) minority interest (e.g., where a franchisee makes a gift of a fractional interest in the franchise).

The major problem has been the

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IRS' antagonism toward these discounts when the franchise is transferred to family members.

Discounts for Family Transfers

The basic issues with respect to valuation of family-controlled entities come up in the gift and estate tax areas. The key issues are (1) whether family relationship defeats the eligibility for a minority discount, and, (2) if it does not, as all the case law has found, then what is an appropriate valuation method for the family-controlled entity and, from that value, what is an appropriate discount?

The IRS has often argued that family relationship prohibits taking minority or lack-of-marketability discounts. It has consistently lost. The leading case in the area is *Bright v. U.S.*, 658 F.2d 999 (CA5-1981). In that case, the government's position was that the relationship between the decedent, executor or legatee, on the one hand, and another stockholder, on the other hand, was a fact relevant to value. But the court's opinion held that family attribution based on the identity of the decedent, the executor or the legatee is irrelevant.

The *Bright* case has been followed repeatedly and cited by the tax court as the leading case in the area. However, it should be noted that there was a dissenting judge in *Bright* who was not very pleased. Judge Alvin B. Rubin wrote:

> It requires my brethren ten pages of manuscript to explain why they affirm the valuation for estate tax purposes of stock at an amount that is but 27 percent of the value that the taxpayer's own experts placed on that stock's pro rata share of the corporation's "public value." Thus, stock that, according to the bearish view of the taxpayer's appraisers, would have a "public value" of $4.4 million is valued at $1.2 million for tax purposes.

The dissent and the IRS were very antagonistic to a 73 percent discount. The court allowed a combined 50 percent discount for lack of marketability and minority interest, and an additional 23 percent discount because of certain loan agreements that were found to affect the value of the stock.

Many franchisees are unaware of these difficult legal issues. The best practice is for the franchise system to provide its franchisees with an outline about discounts, so that the franchisees may reduce their tax burden as much as possible. However, care must be used to avoid giving legal advice. This is usually overcome with a disclaimer.

Availability of § 6166 and § 2057

Internal Revenue Code § 6166 provides the opportunity for an estate, which primarily comprises assets of closely held businesses, to defer payment of the estate tax liability. The estate can defer payment of amounts attributable to the interest in a small business for a period of 15 years, with interest only being paid on the tax liability for five years. After the initial five-year period, the tax liability is then retired with interest in 10 equal annual installments. This deferral can be quite beneficial when the franchise is continued as a "going concern" by the family of the franchisee, since family members can effectively finance a potentially large estate tax liability over a period of 15 years.

For instance, in the hypothetical case of Max Landers, if his children qualified as successor owner-operators for a portion of a franchise or all his franchises after his spouse's death, and the technical requirements of Code § 6166 were met, the estate tax liability could be financed over a 15-year period. The children thereby avoid having to liquidate a portion of the business to pay the estate taxes. Naturally, Code § 6166 has many technical requirements for qualification. Therefore, franchisees should be extremely careful to ensure the use of this tax deferral technique.

Sec. 2057, which reduces estate taxes for qualified family-owned business interests (QFOBI) was originally added to the Code by the Taxpayer Relief Act of 1997. Public Law 105-34, § 502(a), effective for decedents who die after Dec. 31, 1997.

Certain original problems were resolved by technical corrections in the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105-34, § 6007(b), effective for decedents who die after Dec. 31, 1997) by confirming that the benefit is a deduction and renumbering the provisions as § 2057.

This is a very complicated benefit that appears to shelter a family business to the extent of $1.3 million but really provides little more than a $400,000 deduction. See Schumacher, Jon L., "Qualified Family-Owned Business Interests Under I.R.C. § 2057: This Road Is Still Under Construction," NYSBA Trusts and Estates Law Section Newsletter, Vol. 31, No. 4 (Winter 1998). More important, there will be full recapture of the tax benefit if the qualified heir or successor ceases to materially participate or disposes of the interest within six years after the death. There is partial recapture of the tax benefit unless the qualified heir or successor holds the QFOBI for a full 10 years after the death. In some instances, the election and recapture can cost more than if the election had never been made. *Ibid.*

The best practice with respect to this technical provision is for the franchisor to advise the franchisees in its system about the issue. The franchisees should then be advised to seek professional advice about the possibility of using the provisions.

So, the key to any successful solution to these issues is to plan in advance. There are many technical issues for which professional advice should be sought, but the best practice is clearly for the franchise system to advise its franchisees of the issues.

Regardless of the specific circumstances with respect to a particular franchise system, the general rule should be that candor and openness are the best guidelines. The more information with respect to options and restrictions that is made available, the less likelihood there will be of disputes or bad endings.

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