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Succession Planning for Franchisees

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Of the critical issues facing franchisees, succession planning is one of the most important and most difficult to solve. Succession planning for franchisees involves the legal, financial, and tax analyses necessary to arrange the transfer of a franchise, whether by sale, exchange, gift, bequest, or devise. The significant problems that franchisees and their advisors must address include:

- Ensuring the certainty of transfer, especially in the case of unexpected death.
- Obtaining the economic benefit from the franchise while maintaining control over operations. How can franchisees make certain that all of their children benefit from the transfer if only one child is the authorized transferee?
- Valuing the franchise for estate tax purposes. This is an area where much of the necessary planning information is available to the franchisor but not generally to the franchisee.

In many respects, a franchise is a unique asset and traditional succession planning techniques may not apply. Because the franchisor exercises so much control over the transferability and, thus, the value of the asset, sound planning requires considerable input from the franchisor as well as from estate planners, accountants, and attorneys. This article discusses the franchise-specific problems of various transfer methods, reviews the income and estate tax elements involved in transfers, and addresses related franchise valuation issues.

First Things First: Basics for Succession Planners

A hard-working franchisee, by following the franchisor's methods, can build his or her operation into a very valuable asset. But the restrictions in a franchise agreement often make developing a sensible estate plan far more difficult than for a sole proprietor or the owner of a closely held business.

Usually, the estate planner's first concern when the client is the proprietor of a successful business is estate tax planning. Estate planning for a franchisee requires considerable attention to the devise or transfer itself because the flexibility available to the typical business owner often is absent.

The principal transfer issues for franchise owners include:

- Franchise agreement restrictions on the transfer and the need to obtain franchisor approval for the transfer
- The franchisor's right of first refusal
- Selection of a transferee
- Spousal transfers and the related dangers of overfunding of the marital bequest and "bunching" assets in the spouse's estate
- Valuation methods
- Assorted other problems, such as the ability to defer the payment of estate taxes to take advantage of lower interest rates or the increased estate tax deduction available for family-owned businesses

Tread Carefully with Transfers

Under the Federal Trade Commission Rule and most state statutes regulating franchising, a franchise prospectus must include a section concerning renewal, termination, repurchase, modification, and assignment of the franchise. These agreements typically place severe restrictions on the franchisee's right to alienate the franchise freely.

In its *Franchise Opportunities Guide*, the International Franchise Association cautions prospective franchisees to look at these provisions carefully:

> 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)?[1]

A typical franchise agreement transfer provision reads:

> 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 restriction enables franchisors to enforce their standards and ensure systemwide uniformity. Failure to comply with these restrictions becomes cause for termination of the agreement, and the franchisee trying to go against the franchisor's demands may well end up with no franchise at all. For that reason, if nothing else, the specifics of the franchise agreement must be carefully reviewed. Franchisees are far better off knowing about these terms before they design a succession plan.

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An unexpected death can lead to even more contentious estate transfer and valuation problems. Most planning options evaporate after the death of the franchisee. To complete a transfer of a very substantial asset within one year of death, as some franchise agreements require, without the guiding hand of the franchisee is very difficult and can usually be accomplished only by a distress sale. When the franchise comprises a major portion or all of the estate, the implications are obvious for the heirs.

It's Mine—Why Can't I Transfer a Franchise?

After meeting with the client and reviewing the relevant franchise documents, a practitioner would be well advised to contact the franchisor's legal department before creating an estate or succession plan. Otherwise, the plan may appear to do wonders for the franchisee but be unacceptable to the franchisor.

To cite one common problem: some franchisors are opposed to plural ownership so that a franchisee who wants to pass ownership on to more than one child may encounter significant resistance. Successful franchisors are prudent businesspeople who learn from their mistakes. A franchisor that found that a substantial number of units owned by partners ended up in court, thereby causing the franchise operation to suffer and thus reducing the franchisor's royalty receipts, understandably would be loath to condone any form of plural ownership of its franchises. Several major franchisors allow more than one owner per franchise only when they are married, thus eliminating potentially fractious siblings and partners. Of course, this is not always the case. Many franchisors do allow plural ownership or at least minority ownership but require that owner-operators maintain control or devote substantially all of their time to the franchised business.

Often a franchise agreement gives the franchisor a right of first refusal when a franchisee seeks to transfer the franchise.

Although franchisors will rarely prevent a sale to a qualified outsider, they frequently will not allow a devise to a partnership of working siblings. The practitioner may have no recourse except to recommend a predeath sale, which offers none of the current income tax benefits of a stepped-up basis, over a normal devise to the children.

Most franchisors are willing to work with the representatives of a franchisee's estate to arrange an orderly and profitable sale if an appropriate heir is not available as a qualified owner-operator. However, the franchisor's input should be solicited during the early planning stages. Only after consulting the franchisor will the practitioner know what can and cannot be done. Once the specifics of the allowable succession have been defined, the practitioner can proceed to address the remaining problems.

A practical note: Because of the contractual restrictions and time restraints on orderly transfer of a franchise, which may be the largest asset of the estate, the use of life insurance should be considered to pay for estate taxes and bequests to those who will not share in the franchise after the franchisee's death.

Franchisors May Hold the Right of First Refusal

Often a franchise agreement gives the franchisor a right of first refusal when a franchisee seeks to transfer the franchise. This should reduce the value of the franchise in a "fair market value" determination because it is a further restriction on transfer. A franchisee interested in selling the franchise must follow the steps dictated in the franchise agreement granting the franchisor the right of first refusal. This is generally done after the franchisee has agreed to all of the material aspects of the deal with the proposed transferee.

Furthermore, the franchisee who seeks to transfer a franchise must be aware of the acceptable types of transferees within his or her own franchise system. This is another reason why the practitioner working on a succession plan for a franchisee must review the proposed plan with the franchisor.

Sale versus Bequest

The decision whether to transfer a franchisee's interest by sale or bequest depends primarily on the transferee (spouse or family member versus an arm's-length buyer) and on tax considerations. The current income tax rate on capital gains, assuming that the holding period is properly established, can be as low as 18 percent to 20 percent. The estate tax presently takes effect at a 37 percent rate and rises to 55 percent on taxable estates of more than $3 million.

However, under the present Internal Revenue Code (IRC) section 1014,[2] an asset held until death receives a stepped-up basis equal to fair market value (the value reported on the estate tax return) on the date of death. There is also an unlimited marital deduction, which can be used to defer the estate tax, for assets left to a surviving spouse.

Lifetime transfers can be effected by outright sale or exchange, either through corporate reorganization or the use of IRC section 1031; installment sale for both cash-basis and accrual-basis taxpayers; or sale for an overriding royalty.[3]

Family succession transfers can be done inter vivos or at death. Lifetime giving can be accomplished by using the annual exclusion under IRC section 2503 as well as the valuation discounts discussed below. A franchisee can also transfer the franchise to a family entity (LP, LLP, LLC, or other alphabetic combinations) and then make lifetime gifts of interests in the family entity. Franchisor approval is required in any case.

Something that should be avoided, if possible, is transfer-

ring the franchise to an S corporation, or, if already so held, transferring the stock of the S corporation. Upon death, the S corporation stock gets a stepped-up basis (the outside basis) but the assets of the S corporation, i.e., the franchise, equipment, etc., do not (the inside basis). This result is easily overcome by using an entity taxed as a partnership and making an IRC section 754 election.

Transfers at death can be accomplished by outright devise, by qualified terminable interest property, by marital or other testamentary trust, or by the use of a qualified domestic trust if a surviving spouse is not a U.S. domiciliary. Frequently, the key element in determining the mechanism of transfer is the amount of income tax, estate tax, or both.

Spousal Transfers and Overfunding the Marital Share

An effective deferral of estate tax liability can be obtained through the use of the marital deduction for transfers between spouses under IRC section 2056 for estate tax purposes and under IRC section 2523 for gift tax purposes. Utilization of a marital deduction is merely a deferral of estate tax and not avoidance since the amount of property transferred will eventually be taxed in the estate of the last spouse to die. Of course, if a transfer to the spouse would not comply with the requirements of the franchise agreement, the franchise must be sold to a third party and the proceeds transmitted to the spouse.

Many franchise agreements are quite liberal in qualifying the surviving spouse of a deceased franchisee as the successor franchisee so that the franchise may continue in the family as a going concern. This may present the problem of bunching of assets in the estate of the surviving spouse if the assets of the first spouse to die are insufficient to fund a credit shelter trust, which is commonly used to take advantage of the marital exemption against estate taxes. The transfer to the surviving spouse postpones the payment of estate taxes, but does not address the restrictions on transfer or the difficulty of equalizing gifts to children.

Assigning a Cash Value to the Estate

IRC section 2031 generally requires imposition of the estate tax on the fair market value of the deceased's estate at the time of death.[4] Franchises present unique problems on this point since the franchise contract in theory terminates with the franchisee's death and has no lasting value. Under such an approach, the only amounts included in the gross estate of the deceased would be the value of the so-called hard assets of the franchise, including equipment, inventory, and leases. This value is substantially less than the going-concern value of the franchise.

In most cases, however, a franchisee's rights do not terminate at death. Many franchisors are liberal concerning the sale of the franchise to a qualified third party or, in many cases, with regard to qualification of the spouse of the deceased franchisee as a successor owner-operator. On the other hand, a forced sale to a third-party owner-operator should, at least in theory, depress the value of the franchise.

Given these various uncertainties, the proper valuation of a franchise for estate tax purposes presents a unique challenge to practitioners and appraisers. In many cases, the value may depend on the transfer restrictions and difficulties that the franchise agreement actually engenders.

Lack of Marketability and Its Effect on Value

A business is worth more if it is freely transferable than if there are restrictions on transfer, as there always are with a franchise. Accordingly, a proper valuation of a franchise will have to include that lack of marketability as a discount. Moreover, if more than one person owns the franchise (even if husband and wife or parents and children), a discount for the position of minority owners is also appropriate.

According to one comparison of restricted and freely traded stock, restricted stock for smaller companies consistently sold at a 35 percent discount.[5] In a valuation for estate tax purposes, reductions of this sort can reduce the estate tax liability, although they also result in the distributee receiving a lower basis for income tax purposes. However, the potential built-in gain would only be at income tax rates (approximately 20 percent on capital gain) while the estate tax inclusion could yield rates of up to 55 percent.

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If, on the other hand, the valuation is part of a divorce proceeding or a partnership dissolution, the lower valuation may result in the nonowner spouse or partners feeling that the discount is inappropriate and prejudicial to their interests.

As valuations have become increasingly important, the courts and the IRS have become dramatically more aware of valuation issues. The courts certainly appear to have become more comfortable with making real valuation decisions rather than relying solely on expert opinions. There has been a substantial rejection of valuations based on allegedly comparable companies that the courts have found are, in fact, totally dissimilar.

The courts have also recognized the importance of professional credentials and qualifications of business appraisers while holding that other professionals with credentials in other fields (e.g., accountants) are not necessarily knowledgeable in business valuations. Also, the IRS has hired more trained business appraisers for its staff, including many certified by the American Society of Appraisers or the Institute of Business Appraisers.

The key issue concerning valuation of family-controlled entities is whether family attribution defeats the eligibility for a minority discount. If it does not, what is an appropriate valuation discount? The IRS has often asserted without success that family attribution prohibits taking minority or lack-of-marketability discounts.[6] The leading case in the area is *Estate of Bright v. United States*,[7] in which the Fifth Circuit recognized the distinction between the minority interest discount and the lack-of-marketability discount. Shortly after the *Bright* decision, the Tax Court adopted the reasoning of the Fifth Circuit in *Estate of Andrews v. Commissioner*.[8] *Andrews* is worth noting because the Tax Court specifically differentiated between lack-of-marketability and minority discounts and followed *Bright*'s reasoning, ignoring the IRS's "family attribution" argument that would have totally disallowed discounts.

How Should a Franchise Be Valued?

The three basic methods for computing the value of a business are: (1) capitalization of earnings, (2) net asset value, and (3) comparable sales. The appropriate discounts can be applied once a method is determined for valuing the entity. Franchises present unique problems in the area of valuation. The normal methods of discounted cash flow and comparable sales have to be adjusted because of the risks of nonrenewal and termination as well as the requirement to obtain the franchisor's consent to a transfer. The costs of franchise renewal also must be considered. Often, renewal terms require the franchisee to execute the then-current form of the franchise agreement and to refurbish signage or interiors or other physical elements.

In the franchise case, the choice of valuation approach turns first on whether the family entity is an active business or an investment company. Although no single method is generally mandated, where the franchise is found to be an active business and comparable sales data are not available, the capitalization-of-earnings method is normally preferred. If it is primarily an investment company, the IRS requires that the net asset value be used.

The objective of a franchise appraisal is to provide an approximation of fair market value, which is defined in accordance with Revenue Ruling 59–60 and the appropriate IRC sections and regulations. However, in the real world of business, things do not always work according to business appraisal theory. For example, it has been said that the classic definition of "fair market value" as "the price that a buyer could be expected to accept" does not apply in the real world. Real-world buyers and sellers of midsize and smaller businesses do not apply either sophisticated financial theory or business appraisal methodology when deciding what price to offer or accept. Instead, most will judge the value of the business by simple criteria, such as price in relation to revenues, earnings, cash flow, or pay-back periods.

Additionally, there is strategic value and synergistic value. However, these are buyer-specific value adjustments and by definition do not conform to a standard meaning of "fair market value" that supposes a hypothetical willing buyer and willing seller, neither of whom is under any compulsion to act. That the buyer and seller are "hypothetical" precludes giving them the specific characteristics necessary to determine strategic value and synergistic value. For example, only a franchisor, as a potential acquirer, would reap the additional benefit of becoming the complete owner of all trademark rights in a purchased territory. Any other outside buyer would be merely a licensee subject to restrictions.

Conclusion

Succession planning for franchisees involves many complex issues. Franchise systems should foster the economic benefit of the entire 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 system.

Endnotes

1. INTERNATIONAL FRANCHISE ASS'N, FRANCHISE OPPORTUNITIES GUIDE 45 (Spring/Summer 2001).
2. All references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
3. *See* Bruce Schaeffer, *Tax Aspects of Franchising, in* BUREAU OF NATIONAL AFFAIRS, 559 TAX MANAGEMENT PORTFOLIO II.F.
4. *See also* Rev. Rul. 59–60, 1959–1 C.B. 237.
5. *Valuing a Business*, FORBES MAGAZINE, Apr. 11, 1994, at 98 (quoting Shannon Pratt of Willamette Management Assocs.).
6. *See* Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981); Estate of Andrews v. Comm'r, 79 T.C. 938 (1982) (addressed the issue of multiple-level discounts involving minority interests in a holding company that owned minority interests in other companies); Roy O. Martin, Jr. v. Comm'r, 50 T.C.M. 768 (1985) (rejected IRS argument with respect to family attribution and allowed minority interest and lack-of-marketability discounts); Ward v. Comm'r, 87 T.C. 78 (1986).

The courts also held that the use of public companies as comparable valuation criteria was not acceptable with respect to a closely held company and allowed two separate discounts. Northern Trust Co. v. Comm'r, 87 T.C. 349 (1986) (25 percent for a minority interest and 20 percent for a lack of marketability); Estate of Saul R. Gilford, 88 T.C. 38 (1987) (allowed a 33 percent discount on the value of restricted stock in a publicly traded corporation and a 25 percent discount for minority interest and lack of marketability). Moreover, in *Estate of Ralph E. Lenheim*, 60 T.C.M. 356 (1990), the court respected a decedent's gifts of stock to his children three months before his death as changing his interest from control to minority.

7. 658 F.2d 999 (5th Cir. 1981).
8. 79 T.C. 938 (1982).