Succession Planning for Franchisees

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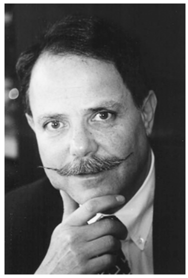

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Succession planning for franchisees is a current imperative because there is a demographic onslaught approaching the franchise sector; it's coming at a time when there is a stark lack of foreseeability with respect to estate and gift taxes. Baby boomers are reaching retirement age in staggering numbers and the new president has promised to repeal the estate tax.

At a minimum, franchisees must consider the topics below that apply to them and devise and implement appropriate plans and solutions—complete with the required documents and procedures.

(1) **Succession Plan**—This is a business contingency plan. The question to be asked is what happens if the principal leaves his or her business for lunch and is killed by a bus or a stray bullet? What, if any, are the restrictions in the franchise agreement that apply to transferees?

(2) **Estate Plan**—This is a dispositive scheme that first must consider a possible sale and, after that, is generally accomplished by wills, trusts, LLC agreements, shareholders agreements, family partnership agreements, life insurance trusts and/or other revocable and irrevocable trusts.

(3) **Estate Tax Plan**—This is a consideration only where the estates are worth more than $5.49 million under the current estate tax scheme. But who knows what the situation will be under the new administration? Currently many franchise owners have assets worth far more than the threshold for estate taxation. With combined federal and state estate tax rates exceeding 40 percent, advance planning is essen-

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tial. People with these types of success problems must consider valuation discounts for lack of marketability and other discounts and must consider how any such estate tax liability will be met to avoid a forced liquidation.

(4) **Valuation**—If a franchise owner is going to sell, or die and dispose of his or her franchise company by bequest, the value of the business must be determined. It is not only an essential element in any estate tax planning to know the value of the franchise on which the tax is potentially to be levied, but valuation is a key factor in all exit strategy planning.

I. Getting Started on a Succession Plan

A succession plan is a set of directions that may not be properly part of a franchise owner's estate plan and, therefore, would not be included in documents such as a will or revocable trust. But it is equally as important. The key considerations in formulating the succession plan are:

(1) Who will run the franchise business if the principal is incapacitated or dies?

(2) Should the business be sold, continued, or liquidated?

(3) If there are questions about 1 and 2 above, who should be consulted? What adviser will have all the facts, and hopefully answers?

Because most franchise owners are novice sellers, many may make mistakes, including:

- They often lack preparation. Sellers should have a plan/strategy to sell well in advance of making the sale. For most franchises, this should be at least three years out.
- They often will fail to have an accurate valuation done on their business by a qualified third party expert. This in turn, may give sellers an inflated view of the value of their business.
- They fail to organize the books and records.
- Customer/vendor/employee issues are not dealt with properly prior to sale.
- They lose their motivation, passion, commitment, and momentum when they consider sale or retirement. Instead, if they want to sell the business, they should try to increase revenue because increasing sales are important to buyers as they analyze trends.
- They fail to de-emphasize the owner's personal role in the business.[1]

1. *See* David Wolinsky, *Mistakes to Avoid When Selling Your Chain*, INC.WELL (Aug. 31, 2012, 9:57 AM), http://www.nbcchicago.com/blogs/inc-well/Mistakes-to-Avoid-When-

A. *Demographics*

Here are some statistics: there are approximately seventy-five million baby boomers in the United States[2] and more than five million similarly situated in Canada.[3] Most are on the verge of retirement. For the next few decades, an average of 10,000 people each day will reach age sixty-five (one every eight seconds), which has historically been the retirement age.[4] Between 2000 and 2010, the number of people age sixty-five to eighty-four in the U.S. grew by 3.3 million.[5] Although a little more than 13 percent of Americans are currently age sixty-five or older, that proportion will jump to 18 percent by 2030.[6] The current forty million senior citizens will balloon to eighty-nine million by 2050.[7] In the case of franchise owners approaching retirement age, generally the most valuable asset they own—indeed often far more than 50 percent of their net worth—is tied up in their franchise companies. Additionally, many who have not been involved in franchises previously may have retired from other work and bought franchises as part of the "new retirement work scape," according to a 2014 Merrill Lynch Retirement Study.[8]

Boomers are currently starting their own businesses in record numbers. According to the Kauffman Index of Entrepreneurial Activity, 23.4 percent of new entrepreneurs in 2013 were aged fifty-five to sixty-four.[9] Part of the reason is that when older workers are downsized, it can take nearly twice as long for them to find new jobs so it makes sense to many boomers to start their own companies. Franchises are deemed safer than pure start-ups.

Selling-Your-Chain-168026046.html#ixzz25apUF5Ln (quoting Meg Schmitz, senior franchise consultant, FranChoice).

2. Sandra L. Colby & Jennifer M. Ortman, *The Baby Boom Cohort in the United States: 2012 to 2060: Population Estimates and Projections*, CURRENT POPULATION REPORTS (U.S. Census Bureau) (May 2014), https://www.census.gov/prod/2014pubs/p25-1141.pdf.

3. David Parkinson, et al., *Boom, Bust, and Economic Headaches*, GLOBE & MAIL (Jan. 5, 2017, 3:26 PM), http://www.theglobeandmail.com/globe-investor/retirement/the-boomer-shift-how-canadas-economy-is-headed-for-majorchange/article27159892/.

4. D'Vera Cohn & Paul Taylor, *Baby Boomers Approach 65–Glumly*, PEW RESEARCH REP., Dec. 20, 2010, http://www.pewsocialtrends.org/2010/12/20/baby-boomers-approach-65-glumly/.

5. *The Older Population: 2010*, 2010 CENSUS BRIEF (U.S. Census Bureau), Nov. 2011, https://www.census.gov/prod/cen2010/briefs/c2010br-09.pdf.

6. *Id.*

7. Sandra L. Colby & Jennifer M. Ortman, *Projections of the Size and Composition of the U.S. Population: 2014 to 2060: Population Estimates and Projections*, CURRENT POPULATION REPORTS (U.S. Census Bureau), https://www.census.gov/content/dam/Census/library/publications/2015/demo/p25-1143.pdf.

8. *Baby Boomers Turn to Franchising During Retirement*, NPI/GPI FRANCHISE BLOG (2014 Merrill Lynch Retirement Study), http://npigpifranchiseblog.com/tag/merrill-lynch-retirement-study/.

9. Robert W. Fairlie, *Kauffman Index of Entrepreneurial Activity 1996–2013*, at 13 (Apr. 2014), http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2014/04/kiea_2014_report.pdf.

B. *Exit Planning—Sale or Other Pre-Death Disposition Options*

It has been argued that when planning a disposition, a franchisee (or any business owner) has only nine options to consider:

(1) Sell or give your company to a family member;
(2) Sell your business to one or more key employees;
(3) Sell to your employees through an employee stock ownership plan (ESOP);
(4) Sell your business to other shareholders;
(5) Sell to an outside third party;
(6) Bring in an outside investor and keep a minority interest;
(7) Go public;
(8) Hire a management team to take over and become a passive owner; or
(9) Liquidate your business.[10]

According to Venture Resources, there are "12 Fatal Mistakes to Avoid When Selling Your Business":

(1) Lack of deal structure expertise;
(2) Failure to adjust the net owner benefit;
(3) Failure to maintain confidentiality;
(4) Failure to secure qualified buyers;
(5) Failure to continue to run your business;
(6) Failure to properly adjust for economic conditions and owner's ability;
(7) Failure to provide credible information;
(8) Poor negotiating techniques;
(9) Failure to place the proper value on your business;
(10) Failure to consider alternative investments;
(11) Failure to prepare for proper due diligence; and
(12) Failure to seek professional assistance and consultation.[11]

Owners of franchises, dealerships, or distributorships must be aware of the legal, financial, marketing, timing, and other vital considerations, most of which should not be made without the advice of the right professionals, that must be addressed in the selling process.

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10. Richard Jackim, JD, MBA, CEPA, an attorney and investment banker on the Board of Governors of the Exit Planning Institute.
11. Venture Resources, *Don't Make These 12 Serious Mistakes*, http://www.venture-resource.com/12-serious-mistakes.html.

II. Franchise Agreement Restrictions and Transfer Procedures

If there is an intent to leave the franchise as a bequest at death, practitioners have to be aware that practically every franchise agreement grants the franchisor a right of approval and often a right of first refusal (ROFR) with respect to any transfer, whether by sale or devise. The franchisee really owns only a contract right, leaving the franchisor in complete control of all transfers, bequests, or both. Thus, the best laid estate and succession plan for a franchisee is worthless if it does not meet the franchisor's requirements.

A synopsis of several sample franchise agreements shows the following:

A. *Planet Fitness (2015) Section 13*

(1) Transfer without prior approval prohibited.

(2) "The proposed transferee and its direct and indirect owners must be individuals of *good moral character* and otherwise meet our then applicable standards for PLANET FITNESS business franchisees." (emphasis added).

(3) If the proposed transfer is for estate planning, transferor (a) must be up to date on royalties; (b) must reimburse franchisor for costs it incurs with respect to the transfer; (c) transferor must execute general release in favor of franchisor; (d) franchisor must give approval; and (e) transferee must sign additional required agreements.

(4) If the transfer is of substantially all the franchise's assets, transferee (a) must have appropriate moral character; (b) transferor must be up to date on royalty payments; (c) transferee and its managers must have completed required training; (d) transferee must agree to be bound by all terms of franchise agreement; (e) transferor must pay $25,000 transfer fee; (f) transferor must deliver general release; (g) franchisor must give approval and have "determined that the price and terms of payment will not adversely affect the transferee's operation of the Business"; (h) if the transfer is seller-financed, transferor must agree that purchase payments are subordinated to royalties and other payments to franchisor; and (i) transferee must agree to be bound by franchise agreement.

(5) Transfer upon death or disability: Owner's executor must transfer the interest in the franchise to a third party; transfer must be "completed within a reasonable time not to exceed 6 months from the date of death and a failure to do so constitutes a breach of the franchise agreement."

(6) Franchisor has right of first refusal (ROFR) on any transfer for 30 days after receiving notice.

B. *Burger King's (BKC) Franchise Agreement (2014) Section 15*

(1) "Any purported assignment or transfer not in full compliance with this Section 15 shall be null and void and shall constitute a material breach of this agreement for which BKC may *immediately terminate without opportunity to cure*." (emphasis added)

(2) Prohibits transfer of the franchise agreement, an ownership interest, or equity securities; also prohibits pledging of the franchise agreement.

(3) Has requirement that transferor be up to date with all obligations, sign a release, and remain liable for at least a year for unpaid royalties and advertising contributions; the franchisor (BKC) has a ROFR and will not answer request for consent to transfer for two to three months. Therefore, there can be no immediate disposition at death. In addition, BKC has right to veto transfer if it impairs cash flow (i.e., if price too high).

(4) Death—must get consent to transfer, subject to ROFR, and must transfer within twenty-four months or BKC can buy at fair market value.

C. *Service Master (2014) Section 12*

(1) Transfer to competitor prohibited.

(2) Transfer to entity—franchisee must retain at least 66 percent of such entity.

(3) Upon the death or permanent incapacity of the franchisee, the executor shall transfer to an approved party within a reasonable time.

(4) If heirs are not accepted as transferees, the personal representative shall have a reasonable time to dispose of decedent's interest.

Thus, these provisions make clear that estate and succession planners cannot just devise a plan that seems to make sense. They must come up with a plan that makes sense *and* will pass muster with the franchisor.

III. Valuation

Valuation is a major consideration in succession planning for franchise owners for two reasons: (1) it allows owners to figure out the total of their estates, permitting them to allocate to recipients according to value (e.g., to all children equally); and (2) it puts a value on the assets and the total estate for estate tax purposes. This is important for tax planning and for computing the basis on which depreciation or amortization is available (income tax considerations) to a successor in interest.

The specialized vocabulary of appraisals and valuations is stultifying and filled with technical terms. Also, some legal and accounting definitions tend to overlap the appraisers' usage although others do not. For example, in fixing the "value" of a business, a practitioner must deal with a whole host of specialized terms, such as discounted cash flows and modified discounted cash flows, price-to-earnings ratios, and price-to-sales ratios, "cap" rates and growth rates, and disputes over whether one business is "comparable" to another.

The major terms used in business valuations are "fair market value," which is a legal term, and "fair value," which is an accounting term. They both generally mean the same thing. Three (and really only three) general methods are acceptable for determining business value. In legal terms, these are book value, capitalization of earnings, and comparable sales. In accounting terms, these methods are known as (1) cost (book value), (2) income (capitalization of earnings), and (3) market (comparable sales). Calculations using other methods or comparisons should be treated with great caution.

- *Book value* is the net worth of a company determined by either its balance sheet assets or the replacement cost of its balance sheet assets minus liabilities.
- *Capitalization of earnings:* This method assumes that the earnings of a business either constitute an annual percentage return on the value of the business or, more accurately, that the present discounted value of all of the business's earnings into the future is the current business value.

  Thus using that method, once the discount rate and the earnings are determined, a value is computed. For example, a 5 percent capitalization rate (sometimes called a discount rate) applied to $100,000 of earnings would yield a business value of $2 million ($100,000 divided by .05 = $2,000,000). This is the same result as a 20:1 price/earnings ratio.
- *"Comparable" sales* are recent sales of similarly situated businesses. Because those prices are not estimates but actualities, the comparable sales method is generally preferred as the most realistic proof of fair market value.

Business goodwill vs. personal goodwill—Valuation analysts are often asked to identify and quantify the company-owned entity's goodwill, separately from the shareholder-owned personal goodwill, in the valuation of a closely held company such as a franchise. These goodwill valuations may be relevant for gift and estate tax, company sale proceeds allocation, and family law and other litigation purposes.[12] Therefore, estate planners should be aware of the factors to be considered when allocating goodwill between the entity and the owner.[13]

12. Bross Trucking, Inc. v. Comm'r, 107 T.C.M. (CCH) 1528 (2014).
13. *See, e.g.*, Robert Reilly, *Separating Personal Goodwill from Entity Goodwill in the Closely Held Company Valuation*, http://quickreadbuzz.com/2015/12/02/personal-goodwill-entity-goodwill/.

IV. Nuts and Bolts of Succession Planning

Succession planning should be a tailored and personal process. The succession plan must incorporate the unique features of every situation. However, there are certain common themes that run through succession planning:

A. *Ownership and Management*

A basic consideration in business succession planning is whether ownership will be segregated from the management of the business. Some franchisees may have children who will remain or become owners in the business, and the question becomes whether they have the requisite experience and skills necessary to manage and operate the franchise. Other considerations include whether the children have the respect of the franchisee's key employees. Additionally, the children should articulate a vision for the future of the business and should be onboard with the timing for the succession of the business.

Whether or not the children are fit to succeed as managers of the business, the franchise owner must ensure that a proper compensation plan is in place to retain the key employees of the business to ensure its future success.

B. *Advisory Team*

In designing and formulating a business succession plan, a franchisee should be supported by a team of specialists. An advisory team should include a CPA; financial advisor; valuation specialist; and, of course, a tax and estate planning attorney. Navigating the succession process requires both technical skill as well as judgment calls. The business owner needs to be informed as much as possible.

C. *Conflict Between Passive and Active Owners*

A common source of dispute in family-owned businesses is when there are both active as well as passive owners. Generally, family members who are not active in the business would like to receive tax-advantaged dividend distributions or even proceeds from the sale of the company. Additionally, nonactive family members may feel that the active owners are receiving excessive salary and other benefits from the business. In the event the company does not issue any dividends, the family conflict may become even more pronounced.

Active owners in the family business generally believe that their efforts and work on behalf of the company is what allows the enterprise to profit, and therefore dividend distributions are unwarranted. Active owners may also be resentful that passive owners benefit from their labor.

The economic strain that the passive family owners may place on the business operations through distribution or buy-out demands may have an adverse effect on business operations. It is always recommended that the active family owners provide financial transparency into the books and records of the business to minimize conflict and even consider a buyout to eliminate the "distraction" the tension may cause.

D. *Senior Generation versus Junior Generation Control*

Often founding members and owners of an operating business are not willing to abdicate responsibilities, even if they have children who are willing to take up the mantle of leadership. The senior generation risks having the younger generation leave the business in search of other opportunities. The younger generation may even set up a competing company to implement their vision.

One possible solution is to recapitalize the interests in the business to give the older generation a preferred class of stock and the younger generation non-preferred equity. This would allow the senior generation to retain substantial control of the business while incentivizing the younger generation to remain in the company. Sometimes, however, the franchise agreement does not allow such solutions.

E. *No One Qualified to Succeed*

Oftentimes, a business owner may not have children interested in taking the helm of an operating business. Even if the children are interested in the business, they may not have the skills to manage it. In either case, the founder is not out of options. He or she can still arrange to have the company sold upon death or retirement. But if such a plan is not in place, there is a risk of incompetent successors running the business into the ground; that inures to no one's benefit.

F. *Employee Succession*

An employee stock ownership plan or ESOP is a qualified retirement plan that allows employees to purchase and own stock of the employer. The ESOP can be funded either by the company by issuing new shares of its own stock or cash to buy its existing shares for which it can sometimes also use leverage. The company can make a tax-deductible contribution to the ESOP to buy out the owner's shares, which often can be accomplished on a tax-deferred basis. An attractive feature of the ESOP sale is that control of the company can remain in the hands of the owner/founder.

The drawback of an ESOP plan is that its administration can be somewhat costly and complicated. And, if it's not done right, there could be adverse tax and business consequences.

G. *Life Insurance as Succession Planning Tool*

Life insurance can be an integral part of a business succession plan. First, the death benefit from a policy can mitigate the estate tax impact. Second, life insurance proceeds can provide estate equalization for children who are either not active or not involved in the family business. Generally, the policy should be owned by an irrevocable life insurance trust (ILIT) so that the death benefit proceeds are not includible in the insured's estate and not subject to income tax.

V. Estate Planning

A formal estate plan is generally made up of legal documents that are a blueprint for the disposition of assets upon the death of a franchise owner. The documents most often used, particularly for owners of franchises, dealerships or distributorships who may be subject to estate taxes, are:

(1) Pour-Over will

(2) Revocable Trust

(3) Durable Power of Attorney (Financial)

(4) Durable Power of Attorney (Health Care)—a/k/a "living will" or "health care proxy"

(5) HIPAA Form

(6) Irrevocable Life Insurance Trust

(7) Grandchildren's Trust

(8) GRIT, GRAT or GRUT

(9) Charitable Lead Trust or Charitable Remainder Trust

We will comment briefly on the first four of these documents. A discussion of the rest is beyond the scope of this article.

A. *Will versus Revocable Trust*

A last will and testament disposes of a decedent's probate assets, which are assets that do not pass by operation of law, while non-probate assets pass by operation of law. Examples of non-probate property include jointly held property as well as annuities, life insurance policies, and retirement accounts that do not list an estate as the designated beneficiary. A "pour over" will is generally used to leave assets to a revocable living trust when that is used as the main dispositive instrument.

A revocable living trust is a trust agreement that can be amended or revoked by the settlor at any time. A revocable living trust does not serve any estate tax or asset protection purpose. The primary purpose of a revocable living trust is to avoid probate court. In states in which probate fees are based on the value of the probate estate, avoiding probate can save significant amounts of money. It can also avoid the delays and vagaries of dealing with probate courts and their judges.

Neither method can be deemed the superior option for bequeathing assets. It all depends on the facts and circumstances. The one drawback with a revocable living trust is that it must be funded to operate as designed. In other words, to avoid probate on what would generally be considered probate assets, the assets must be titled in the name of the trust before death. Individuals who set up revocable living trusts but fail to comply with this administrative requirement may therefore defeat the purpose of the living trust.

Franchise owners who desire to avoid probate should consult their franchise agreements to see if interests in the franchise can be transferred to a revocable living trust.

B. *Durable Power of Attorney*

A durable power of attorney is a legal directive that gives an agent the legal authority to act on a principal's behalf while the principal is alive. The authority can be effective either immediately (durable power of attorney) or upon the occurrence of a future event (springing power of attorney). The future event is usually the incapacity of the principal. However, practically all powers of attorney cease to be effective upon the death of the principal, revocation by the principal, or the incapacity of the agent.

The powers of an agent can be as broad or as limited as the principal directs. Many states have an official form for power of attorney and the applicable state statute must be consulted. Franchisees should have a duly executed financial power of attorney so that in the event of incapacity someone is authorized to handle their business affairs to ensure the continuity of business operations.

C. *Health Care Proxy/Living Will*

A health care proxy (also known as a durable power of attorney for health care, medical power of attorney, or appointment of a healthcare agent) lets an individual appoint another person to make health care decisions in the event of incapacity. Appointing a health care agent is one of the most important things one can do to ensure that one's health care wishes are complied with.

Typically, the health care proxy goes into effect when a person is unable to communicate his or her wishes due to a temporary or permanent injury or illness. A living will, which generally provides a statement of the patient's wishes rather than simply empowering an agent, differs from a health care proxy. Both documents should be in place.

D. *Transfers to Trusts*

A trust is a tripartite instrument whereby the original owner's (grantor, trustor, settlor) interest in the ownership and title to assets are transferred to a legal owner (trustee) for the benefit of a beneficial owner (beneficiary). The trustee manages the trust for the benefit of the beneficiaries. A transfer to an irrevocable trust during the franchisee's lifetime will remove any appreciation in the asset from the franchisee's estate and generally protect the asset from the franchisee's creditors (assuming no fraudulent transfer).

If franchisees transfer their interest in the business to a trust during life or via a will, sometimes one or two important considerations will arise: (1) appointment of trustee and (2) appointment of trust protector.

1. Who Should Serve as Trustee?

If franchisees deem it prudent to transfer their interest in the franchise to a trust, either while they are alive or upon death, they must carefully consider who should serve as trustee. If the transfer is to an irrevocable trust and is being made for estate tax or asset protection purposes, the franchisee should not serve as trustee.

Although trustees have the fiduciary duties of faith and loyalty to the beneficiaries of the trust, they will have voting, distribution, and investment decision-making powers. Accordingly, whoever the franchise owner appoints as trustee of either an inter-vivos or testamentary trust should be someone that the franchisee believes will look out for the best interest of the beneficiaries and also possesses the business skill and acumen to make the right decisions or hire the right advisors if he or she does not have those skills.

2. Trust Protector

Often, clients feel more comfortable transferring or bequeathing assets to a trust in which there is oversight over the trustee. One vehicle through which trustee oversight can be accomplished is through the position of a "trust protector." A trust protector can be given many different powers, including the powers to add or change beneficiaries, change trust situs, and the power to hire and fire trustees. Some states explicitly provide for the position of trust protector by statute and some are silent on the matter. Additionally, some states provide that that a trust protector acts under a fiduciary duty although other states do not explicitly provide either way—the trust agreement can specify.

3. Asset Protection Considerations

We live in an extremely litigious society; franchisees can find themselves being hauled into court for claims arising from the franchisee's business operations (inside liabilities) and claims unrelated to the business operations (outside liabilities). If a customer gets ill or is injured from a franchisee's product (e.g., fast food, cars, vitamins, etc.), the franchisee will likely be listed as a defendant in the personal injury or wrongful death lawsuit. On a personal level, franchisees are exposed to liabilities arising from tort, family disputes, and personal relationships. Accordingly, franchisees should proactively protect their assets from both inside and outside liabilities.

First, franchisees must ensure that they operate the franchise through a business entity, such as a corporation, a trust, or a limited liability company, that offers limited liability. Franchisees must also ensure that their ownership interests in the franchise as well as their other assets are protected from non-business creditors. Asset protection tools range from umbrella insurance to transferring assets to asset protection trusts in both domestic and foreign jurisdictions that have enacted self-settled trust legislation (whereby the grantor can possibly also be a beneficiary of the trust).

4. Limited Liability Companies

The most common entity used for franchised business operations currently is the limited liability company (LLC). An LLC offers two significant benefits: (1) only one layer of tax (as opposed to a corporation that is classified as a C corporation under the Internal Revenue Code which imposes two layers of tax)[14]; and (2) limited liability to the business owners. However, the LLC primarily shields the franchisee from the inside liabilities.

Some things estate and succession planners should know about pass-through entities,[15] such as LLCs, are:

- More than 93 percent of businesses in America are pass-through enterprises. In 2014, 28.3 million out of 30.8 million business establishments were pass-through enterprises.
- Pass-through firms account for more than half of U.S. private sector employment. In 2014, the number of workers at these firms totaled 73 million, compared with 54 million at C corporations.
- The total profits of pass-through firms have surpassed the profits of C corporations. In 2012, the net income was $1.6 trillion for pass-through firms and $1.1 trillion for C corporations.[16]

VI. Estate and Gift Tax Considerations

A. *Estate Tax*

Currently, a 40 percent federal estate tax is imposed on the estate of individuals. Every individual has a lifetime exemption (currently, $5.49 million, indexed for inflation) so the 40 percent tax rate is imposed when the estate is valued at over $5.49 million. Additionally, for married couples, if one spouse predeceases the other, the surviving spouse can utilize the unused ex-

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14. Contrast with a corporation classified as a C corporation under the Internal Revenue Code under which two levels of income tax are imposed—one at the corporation level and then a second level at the shareholder level.

15. Pass-through businesses come in three varieties: sole proprietorships (firms with one owner); partnerships (which includes LLCs for tax purposes); and S corporations, which are corporations receiving pass-through tax treatment. Their number has grown rapidly. In 1980, according to the Tax Foundation, there were more C corporation tax returns filed than the combined total of sole proprietorships, partnerships, and S corporations. By 2012, the number of pass-through returns was more than four times greater than the returns from C corporations. *See* Scott Greenberg, *Pass-Through Businesses: Data and Policy*, TAX FOUND. (Jan. 17, 2017), https://taxfoundation.org/pass-through-businesses-data-and-policy/.

16. Robert J. Samuelson, *Why Tax Reform Will Be a Slog*, WASH. POST, Jan. 18, 2017, https://www.washingtonpost.com/opinions/why-tax-reform-will-be-a-slog/2017/01/18/550ca9b4-dda2-11e6-acdf-14da832ae861_story.html?utm_term=.1b95f7c67e76.

emption of the decedent spouse. Effectively, a married couple has $10.98 million in exemption. No estate tax is imposed for transfers between spouses that qualify for the marital deduction.

Franchisees, especially multiple unit owners, may have assets that exceed this $10.98 million threshold. In order to evaluate and plan for estate tax exposure, a franchisee should obtain an appraisal of all assets, including franchise interests.

It should be noted that under the current law, if a beneficiary inherits an asset from a decedent, the beneficiary receives an income tax basis in the asset equal to the fair market value of the asset on the date of death of the decedent (step-up in basis). Accordingly, if the beneficiary sells the asset and there was no appreciation in value since the date of death, the beneficiary will not recognize any taxable gain for income tax purposes.

In contrast, if a beneficiary receives an asset as a gift during the donor's lifetime, the beneficiary will take the same basis as the donor (carryover basis). Accordingly, if the beneficiary sells the asset for more than the donor's basis, the beneficiary will have taxable gain.

B. *Gift Tax*

In addition to the estate tax that covers a decedent's assets upon death, there is a gift tax (the two combined are referred to as the unified transfer tax) for transfers made during lifetime for less than fair market value in money or money's worth. For example, if a franchisee gifts part of his interest to a child or to a trust for the benefit of a child, that is a taxable gift. As with the estate tax, there is a $5.49 million lifetime exemption. The estate and gift taxes work in tandem—if an individual makes lifetime gifts, the individual lowers his or her estate tax exemption by the same amount.

Additionally, there is an exemption for the "annual exclusion amount," which is currently $14,000. The annual exclusion allows donors to make gifts up to $14,000 to any individual without using up their lifetime exemption. In other words, donors can gift up to $14,000 to every single person on the planet and not use up their $5.49 million exemption. A husband and wife can gift $28,000 each year to as many people as they wish by "gift-splitting."

C. *Valuation Discounts*

For purposes of the estate and gift taxes, the fair market value of the property being transferred to a decedent's beneficiary, or to a donee while the franchisee is alive, is generally:

> [T]he price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.[17]

17. Rev. Rul. 59-60, 1959-1 CB 237.

For purposes of valuing a business interest, the IRS allows, inter alia, discounts for lack of marketability and lack of control. A discount for lack of marketability is warranted because privately held business interests are not traded on public markets and are therefore less liquid. Additionally, if there are restrictions on transfer or control imposed by the franchise agreement or other corporate governance documents, additional discounts may be applied.

In prior years, estate planning advisors made heavy use of these discounts to transfer wealth in the form of family-held business interests to the next generation at a gift and estate tax value, which was often lower than the value of the underlying assets. However, on August 2, 2016, the Treasury issued proposed regulations that would essentially eliminate discounts for minority interests in the family business context. Although this initially caused great panic among estate planning practitioners, it remains to be seen whether the proposed regulations will come to fruition. For tax purposes, the whole issue may become moot if the estate tax is repealed but such discounts would still be relevant for the purpose of buyouts and M&A transactions.

D. *Use of 754 Election for Basis Adjustments*

As a general rule, upon the passing of an individual, all his or her assets receive a "step-up" in basis. A step-up in basis means that the income tax basis of the individual's property gets stepped-up to the property's fair market value as of the date of death. If the decedent's beneficiaries sell that property, they use the fair market value at the date of death as their basis in the asset.

However, in the business entity tax context, two income tax bases must be considered: (1) inside basis and (2) outside basis. Inside basis refers to the basis the entity holds in its individual assets and how that basis is reflected in the entity's capital accounts. Outside basis refers to an owner's income tax basis in the entity itself (e.g., stock, partnership, or LLC interest). Although the technical details are outside the scope of this article, it is possible for a discrepancy to exist between the inside and outside bases of an ownership interest. Upon the death of an owner, the owner's successor-in-interest receives a basis in the entity equal to the date of death fair market value. However, there is no effect on the underlying asset in the hands of the entity.

Accordingly, if the enterprise sells an asset immediately after an owner dies, there is no basis adjustment and the owner's successor-in-interest will report a gain. However, if the entity is a partnership or an LLC and makes a Section 754 election, the successor can adjust his or her share of the inside basis of the assets so that it equals the outside basis. This will allow the successor to recognize a smaller share of gain, if any, than his or her fellow partners if and when the entity sells assets.

A franchisee's advisor should be aware of this election in the event the franchisee owns the franchise interest thorough a partnership or LLC and the entity's assets are worth more than the tax basis on the date of transfer. For example, a Section 754 election would not be desirable if the value of the enterprise had decreased over time and valuation discounts would reduce the decedent's share of inside basis of partnership assets to below cost basis.

E. *Succession Planning Attributes of Various Entities*

The following table shows which attributes are characteristic of the various types of entities:

Attribute	**C Corp**	**S Corp**	**LLC**	**Individual Ownership**
Management Control	Yes	Yes	Yes	Yes
Limited Liability	Yes	Yes	Yes	No
Step Up Inside Basis	No	No	Yes, if 754 election	Yes
Step Up Outside Basis	Yes	Yes	Yes	Yes
Discount–Lack of Marketability	Yes	Yes	Yes	Yes
Discount–Minority	Yes	Yes	Yes	Yes

F. *Trump Estate Tax Proposals*

The current Trump estate tax proposal (as enunciated during the presidential campaign) provides for a complete repeal of the federal estate tax.[18] There is no mention of the gift tax although many practitioners believe that the gift tax will not be repealed because it serves as a backstop to income shifting to lower brackets. Additionally, under the announced proposals, unrealized capital gains exceeding $10 million will be subject to tax.

However, Trump's estate tax proposal does not address whether the current law mandating a step-up in basis in a decedent's assets would be maintained or whether a carryover basis regime would be adopted.

VII. International Operations Considerations

In an increasingly global world where U.S. persons will own franchise interests abroad and where foreigners will own interests in the United States, some familiarity with international tax concepts is warranted. A complete analysis of the international tax rules pertaining to cross-border franchisees is outside the scope of this article. However, the following highlights issues that cross-border franchisees should be aware of.

18. Greg Iacurci, *What Will the Estate Tax Look Like Under Trump?*, Inv. News (Feb. 5, 2017, 12:01 AM), http://www.investmentnews.com/article/20170205/FREE/170209961/what-will-the-estate-tax-look-like-under-trump.

A. *U.S. Owners of Foreign Franchises (Outbound Planning)*

An individual who is considered a U.S. citizen or "resident" is subject to federal income taxation of his or her worldwide income even if the income is not "produced" in the United States. For example, if a U.S. citizen or resident owns a franchise that operates in a foreign country (e.g., a French chocolate franchise operating in Paris) he or she is subject to taxation on that income in the United States. Of course, the franchisee will be entitled to a U.S. tax credit (subject to certain limitations) for taxes paid to a foreign jurisdiction.

United States franchisees with foreign interests should also be aware of the "controlled foreign corporation" (CFC) and passive foreign investment company (PFIC) regimes. The CFC and PFIC regimes are anti-deferral regimes designed to ensure that income earned abroad is not deferred indefinitely. Finally, U.S. persons should consult the applicable income tax and/or estate tax treaties to determine what, if any, exemptions or reduced income tax rates are available.

B. *Foreign Owners of U.S. Franchises (Inbound Planning)*

Non-U.S. citizens and residents who own franchise interests in the United States face a complex variety of issues—the character and source of income derived from the franchise agreement, whether the income is effectively connected with the operation of the U.S. trade or business, and whether or not there is a flat 30 percent withholding tax as opposed to taxation based on the income tax rates in effect. And, as with outbound planning, the applicable income tax treaty must be consulted to determine whether reduced tax rates are available.

On the estate planning side, the U.S. imposes an estate tax on the U.S. situs assets of a non-domiciliary with only a $60,000 exemption. Whether one is domiciled in the United States for purposes of the $60,000 exemption is a question of facts and circumstances. And once more, the applicable estate tax treaty must be consulted to determine the estate tax exposure.