SUCCESSION PLANNING

Franchises and FLPs: Looking at the Benefits And Possible Problems That Franchisees Face

By Bruce S. Schaeffer

Many of the people who have benefited from the explosive growth of franchising over the past 30 years are now aging and preparing an estate or succession plan. The purpose of this article is to explain why they should consider using a family limited partnership (FLP).

FLPs are no longer limited to the well-recognized limited partnership. The full panoply of alphabet soup entities (all treated as conduits for tax purposes) is available, e.g., LLC, LLP, LP, etc. For purposes of this article, all these entities will be referred to as FLPs.

FLPs have many benefits: They are useful vehicles for disability planning, succession planning and estate tax savings. The major benefit of the FLP is the tax savings accomplished through valuation discounts. Lifetime transfers of interests in the FLP reduce the grantor's estate by the gift (as well as future appreciation) while providing discounts on the gift.

Discounts for lack of marketability and for minority interest can frequently lead to a reduction of one-third to one-half of the gift or estate taxes. Commensurate discounts on the FLP interest remaining in the estate of the grantor at the time of his or her death are also available. Therefore, these valuation discounts can yield substantial estate and gift tax savings.

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A franchisee must first look to the specific terms and prohibitions of the franchise agreement. The franchisor may not allow an FLP to own the franchise under the terms of the franchise agreement. However, if the franchisor is cooperative, the gift and estate tax savings of using FLPs, especially for multiple-unit owners, can be extraordinary.

Benefits of FLPs

The disability planning benefit of an FLP is similar to a "living" or revocable trust. In the event of a catastrophic illness—short of death—or the onset of Alzheimer's disease, the FLP can be used to switch control without the attendant tax costs of switching ownership. This can be done by the simple mechanism of transferring ownership in the general partner while the limited partnership interests own the majority of the equity.

Whether or not there is any disability or disease, a succession plan can be implemented by contributing the franchise to an FLP and then gifting interests in the FLP. But great care must be taken to accomplish the steps in the proper order. See, e.g., *Knight v. Commissioner,* 115 TC 506 (2000), where the gift of interests in the property was made before the transfer to the FLP. The tax court disallowed valuation discounts on the creation of the FLP because the property had already been transferred.

Methods of Valuation For Family-Controlled Entities

There are three basic methods followed for valuations: (1) capitalization of earnings, (2) net asset value and (3) comparable sales. Once a method is determined for valuing the entire entity, the appropriate discounts can be applied.

The first decision turns on whether the FLP is an active business or an investment company. Although no single method is generally mandated, if the FLP is found to be an active business, the capitalization-of-earnings method is preferred. If the FLP is primarily an investment company, then the IRS is adamant that net asset value is the appropriate method for determining value. For example, some campground franchises may have land more valuable than the business. The IRS position is laid out in Rev. Rul. 59-60, 1959-1 C.B. 237, particularly in § 5.

Possible Problems

One of the basic issues with respect to valuation of family-controlled entities such as FLPs is whether family attribution defeats the eligibility for discounts.

The IRS has often argued that family attribution prohibits taking minority interest 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 and another stockholder 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 under the case law.

The *Bright* court noted that since 1940, the tax court had uniformly valued a decedent's stock for estate tax purposes as a minority interest when the decedent himself owned less than 50 percent, despite the fact that control of the corporation was within the decedent's family. *Hooper v. Commissioner,* 41 B.T.A. 114 (1940).

The *Bright* court also held that with respect to the analogous gift tax area, the weight of authority also rejected family attribution. The court cited the case of *Estate of Charles W. Heppenstall,* 18 T.C.M. (P-H) P 49,034 (1949), where the donor owned 2,310 shares, which represented more than 50 percent and therefore control of the stock of the family corporation. He made

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Franchises and FLPs

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gifts of 300 shares each to his wife and three children. The government argued that the shares given should be valued as control stock. The tax court rejected this argument, saying that the donor, in making the gifts, surrendered his control over the company but did not convey that control to any one of the donees or to all of them jointly.

The *Bright* decision allowed 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. Shortly after *Bright*, the tax court adopted and followed its reasoning in *Andrews v. Commissioner*, 79 TC 938 (1982), and it was reaffirmed by the Fifth Circuit in *Bonner v. U.S.*, 84 F3d 196 (CA5-1996).

IRS Antagonism

Another possible problem is the IRS' institutional antagonism to family limited partnership and family limited liability companies in general. Having consistently lost in court, the IRS, in the late '90's, came out with new attacks on all family entity discounts. The IRS position was without justification and flew in the face of the congressional history. Nonetheless, in 1997, the IRS National Office issued several rulings holding that no discounts were available in the valuation of interests in family limited partnerships and family limited liability companies, in Technical Advice Memoranda 9736004, 9730004, 9725002, 9723009 and 9719006.

Each of these TAMs was based on truly egregious facts. In each case, the family entity was formed and interests were transferred to the taxpayer's children shortly before the decedent's death. In one case, the decedent was terminally ill and had been removed from life support at the time that the FLP was established. She died two days later.

In the other TAMs, the decedents lived less than two months after the respective family entity was formed. One decedent was 90 years old; the certificate of limited partnership had not even been filed when she died. In the other cases, there were cancer diagnoses and an apparently incapacitating automobile crash. In most of the cases, the decedents could not even accomplish the transfers themselves: The children (the beneficiaries) made the transfers either as trustees or pursuant to a power of attorney. In the last case, the decedent acted on his own but clearly in accordance with the direction and under the influence of his son, who was an estate planning expert and had published an article touting the transfer tax advantages of FLPs.

Recent Decisions

In addition to the family attribution attacks, the IRS has argued that the transfer to the FLP should not be respected because it has no "business purpose" other than tax savings. The IRS has also argued that the anti-"estate freeze" provisions of IRC § 2703 should disallow discounts for lack of marketability and for minority interests. However, in a series of recent cases, the IRS has lost on all these arguments.

In the cases of *Shepherd v. Commissioner*, 115 TC 226 (2000), and *Estate of Strangi v. Commissioner of Internal Revenue*, 115 TC 478 (2000), as well as *Knight*, supra, the tax court threw out the IRS arguments. In *Strangi*, there was a deathbed transfer under a power of attorney, which was six years old, given to the son-in-law (who was a lawyer), and the court still allowed a 25 percent discount for lack of marketability and an 8 percent discount for minority interest. The tax court also confirmed that the "property" that is valued is the limited partnership interest, and not the underlying property (i.e., the franchise). This was a decision reviewed by the full tax court. In *Shepherd*, the real issue was the value of certain timberland. But even there, the IRS stipulated to a 33.5 percent discount for minority interest and lack of marketability.

Nonetheless, the IRS' antagonism must not be ignored and the mechanics and technicalities must be absolutely proper.

Most important, to take advantage of the substantial discounts, the taxpayer must have a formal valuation that must be filed with the gift or estate tax return relating to the FLP transfer.

FRANCHISE RELATIONSHIP

Post-Expiration Covenants Not to Compete: Grant Limited 'Free Agency' to Franchisees

By David L. Cahn

This is the first of a two-part series.

Advocates of "fair franchising" have focused on a wide variety of issues in recent years, as is evident from the breadth of issues addressed in the Small Business Franchising Act of 1999 (the Coble Bill). While some provisions of the Coble Bill are quite controversial and may have limited its likelihood of passage, other provisions address discrete issues that should be addressed—with or without legislation. Perhaps the most significant issue of this nature is the enforceability of post-expiration covenants not to compete.

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Legal Enforceability

A significant amount of commentary has focused on the circumstances in which a franchisor can obtain an injunction to enforce a post-termination covenant against competition. Generally speaking, to enforce a covenant not to compete, a franchisor must prove that the covenant is ancillary to an otherwise lawful franchise contract, and that it is (a) necessary to protect the franchisor, (b) not injurious to the public interest, and (c) reasonable in time, subject matter and territory. See Robert W. Emerson, "Franchising

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