An Overview of Asset Protection, Business Succession and Estate Planning for Franchisees and Business Owners*

For family-owned franchises protecting, maintaining and passing on the family business is not easy. Such businesses are prey to the triple threat of litigation, competing family interests and estate taxes, which can destroy what a family has worked so many years to create.

The Threat of Litigation: Asset Protection and Entity Structuring

Given a legal climate where liability often seems based on net worth and not culpability, a bank account can be wiped out by a lawsuit. Professionals are obvious targets, but family owned franchised businesses also are perceived as having deep pockets, and therefore are equally at risk. Given these treats, asset protection and entity structuring is critical.

Asset protection, which must be instituted before any such problems arise, is simply the process of placing assets beyond the reach of future creditors and claimants. Plans range from the most familiar - transferring title to a spouse - structuring and funding pension plans, forming a family limited partnership (FLP), or creating an asset protection trust (APT). The "traditional" solution to liability exposure has been to obtain insurance. But this solution alone no longer is viable, considering excessive jury verdicts, decline in maximum coverage limits and numerous coverage exclusions. Proper insurance coverage should be combined with bona-fide asset protection planning, which includes entity structuring. Entity structuring is simply the separation of ownership from assets. An example of entity structuring would be a franchised business owned by a corporation; the corporation managed by another corporation or family limited partnership; the assets of the business

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leased from another family controlled entity; and the real estate upon which the business is conducted owned by a third separate family controlled entity. The strategy is to have all the separate entities insulate the owner/franchisee from any personal liability and isolate the assets a lawsuit may affect. Entity structuring techniques have an *additional* benefit of sometimes fostering a modest settlement, as claimants quickly learn that they may be unable to collect any judgment since the bulk of the franchisee=s wealth lies outside the entity being sued.

Combined with entity structuring, other asset protection techniques also include the following:

Family Limited Partnerships (FLPs)

If structured properly, FLPs can protect a Alimited@ partner=s partnership interest from creditor attack, as many states limit a creditor=s remedy to the limited partner=s interest in the partnership. Control also can be maintained by the older generation, which makes it an attractive planning vehicle.

Retirement Plans

Assets placed in a qualified retirement plan, whether be a 401K or an Individual Retirement Account, are exempt from all claims except those of the Internal Revenue Service and marital support obligations. Federal and state law exemptions offer varying degrees of protection of retirement plan assets from creditor claims.

Marital Property Transfers

A common example of marital property transfers is owning the marital home as tenants by the entirety. Where a judgment is obtained against one spouse, the creditor cannot force the sale of the marital home, as public policy prefers the maintenance of a marital home over satisfying a money judgment. Moreover, tax-free transfers often are made from one spouse to the other, to enable both spouses to fully utilize the unified credit.

Asset Protection Trusts

Assets placed into a trust established in Alaska, Delaware or Rhode Island, or in certain asset protection friendly jurisdictions located outside of the United States, such as the Bahamas, may not be subject to the control of a domestic court=s jurisdiction. Again, however, the benefits of bona-fide asset protection can only be achieved if it is implemented at the proper time. Just as you cannot buy fire insurance after you smell smoke, the time to establish asset protection measures is before any problem arises.

The Threat of Competing Family Interests: Business Succession

Graying baby-boomer franchisees approaching retirement have experienced a unique American success story. Having become franchisees during the past 15 to 20 years, they are now successful, and are now reaching their 50s and 60s and beyond. It is at this point that they confront the second and third threats to the wealth they have created, competing family interests and estate taxes.

Keeping it in the Family

The first question to be asked is whether the business should be kept in the family. If so, do the children ***want*** to take over the franchise? If they do, are they capable, motivated, experienced and prepared to take over? Will the passage of the family business cause dissension, since one member of the family may be in a subordinate role?

Providing for an Orderly Succession

Franchise owners generally wish they could pass their companies to their children, like passing a basketball down court to another teammate. But it is not that easy. Once franchisees become aware of the various legal, family and tax concerns they must confront, their goals should include: keeping the business legacy for the family, if possible; ensure good leadership; treating all children fairly; and protecting against creditors, future ex-spouses and outsiders. Franchisees generally have a good idea of who they would like to keep out of their business. That list may include their spouse=s future husband or wife in the event of remarriage, their children=s ex-spouses in the event of divorce, their children=s creditors, or any potential plaintiff who might file a lawsuit against a family member.

And Now for the Bad News: The Threat of Estate Taxes

Estate taxes can take a substantial bite out of the business. They represent a tax on money on which you have already paid taxes. The rate rapidly rises from, 37.5 percent to 55 percent of everything owned or controlled at the time of death. This includes not only stocks and real estate, but retirement plans and life insurance as well.

The Internal Revenue Code presently allows individuals, including franchised business owners, to pass up to $2,000,000 estate tax-free and $1,000,000 gift tax free to family members or others. That estate tax exemption will increase to $ 3,500,000 in 2009. It will be totally eliminated in 2010, but will then be ***reduced*** to only $1,000,000 as indicated by the following table:

Year	Max. Estate Tax Credit	Max. Gift Tax Credit	Max. Unified Rate
2007	$2 million	$1 million	45%
2008	$2 million	$1 million	45%
2009	$3.5 million	$1 million	45%
2010	Tax Repeal	Tax Repeal	0%
2011	$1 million	$1 million	50%

Once gifts or inheritance exceed the unified credit amount, however, the tax rate is 37 percent and climbs rapidly to 48 percent. This does not include the extra 45 to 48 percent Generation Skipping Tax, which is applicable to transfers that are made directly to grandchildren and exceed the $2,000,000 lifetime gift and/or estate tax exemption. Unless you have planned properly to avoid or lessen the estate tax bite, more than half of what you have spent your life building will be taken by the IRS.

Some of the most popular techniques are to achieve the smallest possible estate tax bill include the following:

Lifetime Gift Giving. The Internal Revenue Code allows an individual, including a franchise business owner, to give $10,000 a year to any person, tax-free.

Living Trust Techniques. The use of living trusts can enable a franchisee and his or her spouse to fully exclude at least $1,350,000 where two separate trusts are set up for both the franchisee and his or her spouse. One of the trusts, the credit shelter trust, which has an initial value of $675,000, passes estate tax free at the time of the franchisee=s death and, assuming growth in value during the remaining lifetime of the franchisee=s spouse, will pass to the children or other family members estate tax free at the time of the spouse=s death - regardless of any increase in value that has occurred.

More importantly, all of this is achieved without the franchisee giving up any control over his or her money during the franchisee=s lifetime, as the trust is revocable and does not become effective until the death of the franchisee/trust maker.

Minority Shareholding. Another way to reduce estate taxes is the use of non-controlling shares of a company. The IRS recognizes that a minority share of a closely held, private company is not worth much by itself. For example, 20 percent of a $10 million closely held franchise is not worth $2 million, since the owner of that small share cannot control how the business is run or what dividends it pays. When valuing minority shares, discounts in the 30 to 50 percent range, or even more, are possible because the shares do not control decisions or the operation of the franchise.

Salary Increases. This is a simple way to pass wealth from a franchise owner to children working in the business.

Life Insurance. The proceeds from a life insurance policy can cushion the financial blow of the estate taxes and also can provide wealth equalization for other children who are not involved in running the family franchise.

Effective estate planning requires an estimate of the fair market value of all assets owned by the franchisee, including the franchised business itself. Although conducting a valuation of a traditional, or non-franchised, business is not a simple task, it is much easier than valuating an franchised business.

The franchise agreement details the conditions under which a franchisor will permit a franchisee to sell or even renew a franchise. The necessity of obtaining the consent of another to allow you to sell your business and to approve to whom you may sell is unique to the franchise relationship. In fact, it can be argued that simply by the imposition of external franchisor control, the business is worth less than a comparable non-franchised business. Recent statutory changes and court decisions have made it clear that relevant professional appraisals are necessary to establish the true worth of a franchised business.

Conclusion

As they grow older, franchise business owners must confront numerous personal and tax considerations to determine whether keeping the franchise in the family is the right decision. This article briefly addresses some of those issues.

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